May 17, 2001

ECONOMIC UPDATE

Canada

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Presentation

by the
Honourable Paul Martin, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

May 17, 2001
CHECK AGAINST DELIVERY

Introduction

Thank you, Mr. Chairman, and let me thank the committee for this opportunity to appear before you today.

In the months leading up to today's Update, I have had the opportunity to participate in extensive discussions on the global economy with the G-7 and G-20 finance ministers, the International Monetary Fund and the World Bank; on the North American economy with members of the business community from both sides of the border; and on our economy with a group of key Canadian economists.

Most importantly, since January, I have travelled to every region of the country, meeting with Canadians, participating in informal consultations, town hall meetings and locally based roundtables. In one community after another, the participants were kind enough to share their ideas, their insights, their hopes and concerns, and I want to thank all of those who took the time to do so.

Sometimes, in analyzing data, it is easy to get caught up in the language of economists and statisticians, but we must never forget that while economic activity is reported in numbers, it is experienced in the lives of Canadian families. After all, the "the economy" is not some abstract concept – "out there," "somewhere," "some time." It is the fabric of everyday life; it is the plans people make, the confidence they have and the activities they enjoy.

So it is certainly understandable that when Canadians speak about the economy it is not in the language of rates and ratios. They speak of affording a home, buying groceries or planning their children's education. They talk about their wish for a secure retirement and a health care system that's there when they need it. They also speak of the need to direct the economic strength of our nation to improving the lives of our people. They tell us that economic growth must be aimed at a higher purpose. And that is why a balanced approach is as important as a balanced budget.

Most Canadians I met expressed their confidence in the overall direction of our economy but, naturally, they were concerned about how the current slowdown, which started in the U.S., will affect them and their families. Today I want to speak to those concerns. Specifically, I want to update Canadians on how the global changes that have taken place since last October's Statement have affected our nation's finances and our economic prospects, and to outline the measures we are taking to support growth.

International Economic Situation

Let me begin with the broader international picture.

For an open economy like Canada's, with more than 40 per cent of our gross domestic product (GDP) generated by exports, what happens outside our borders has a direct impact on what happens inside.

At its meetings last month, the International Monetary Fund said that short-term prospects for global growth have weakened and, as a result, projections for growth were lowered from 4.2 per cent to 3.2 per cent for this year. In Europe the pace of economic activity has slowed and is below potential. In Japan, the world's second largest economy, low consumer confidence and fundamental problems in the financial system continue to prevent a sustained recovery.

United States' Economic Situation

In the United States – the economy that affects us most – the slowdown has turned out to be steeper than expected. The U.S. economy started last year growing at an annual rate of 5 per cent, but by the final quarter it was growing at just 1 per cent.

While preliminary estimates for the first quarter of this year show some improvement, the near-term outlook remains unclear. Indeed, the most recent labour force statistics, which showed a decline in U.S. employment, point to this uncertainty. Private sector economists are now projecting that growth in the U.S. will average 2 per cent in 2001. This reflects the widely held view that significantly lower interest rates will pave the way for renewed growth this year. We hope that proves to be the case. But we remain cautious and are taking nothing for granted.

Current State of the Canadian Economy

Clearly, the Canadian economy is feeling the effects of the weaker U.S. economy. Growth here in the final quarter of last year was considerably less than in the preceding quarter, primarily reflecting much slower activity in the automobile industry and in the information and communications technology sector. Both industries, which depend heavily on exports, have faced falling demand from the U.S. In response, both have had to cut back production to deal with excess inventories. These actions, in turn, have had their effect on the Canadian economy, postponing investment decisions and reducing near-term growth.

At the same time, however, there have been a number of encouraging developments which have helped to offset this weakness.

First, other export-oriented Canadian industries, such as aerospace and energy, have continued to grow at a strong pace. Service industries and construction – particularly the housing sector – which are domestically oriented, have also continued their solid performance. This strength in services, aerospace, energy and construction is important because together they produce more than 75 per cent of Canada's total economic output.

Second, Canada's external balance has improved substantially – from a deficit of $28 billion in 1993 to a surplus of $19 billion in 2000. This, in turn, has resulted in a sharp decline in our foreign indebtedness – from 44 per cent of GDP in 1993 to 23 per cent last year, its lowest level since the early 1950s. This decline in foreign indebtedness is significant. Reducing the amount of money that we pay to international creditors gives us greater flexibility to manage our own affairs and keep interest rates low. This is all the more welcome in today's uncertain global environment.

Third, and most importantly, employment continues to grow and Canadians are beginning to see their disposable income rise again. This, combined with large tax cuts and lower interest rates, is supporting solid consumer spending this year.

Mr. Chairman, given the mixed signals on the health of the economy, it is not surprising that there are differing perceptions about its present state. What is important is to put these differing opinions into context. In summary, what is clear is that all of the available facts and figures show that, albeit at a slower pace than last year, the longest Canadian economic expansion since the 1960s – some 22 quarters of growth – is continuing.

Since taking office in 1993 we have consistently budgeted on a rolling two-year basis. Given the uncertainty inherent in long-term projections, this approach has served us well in the past and will do so again in the future. As part of this approach, the Department of Finance surveys some 19 private sector forecasters to obtain their best estimates of the economic outlook. Based on that survey, we then meet with the chief economists of Canada's major chartered banks and four leading forecasting firms to make doubly sure that the average of private sector forecasts is a reasonable basis upon which to plan. This approach ensures that the assumptions we use are realistic and credible.

In preparation for this Update, we have again conducted this process. Mr. Chairman, looking ahead to the next two years, the economists have projected that while the deceleration in economic growth is sharper than previously anticipated, the economy will continue to expand. Where there is less agreement is on the extent of that growth. Indeed, the forecasts for 2001 range from a high of 2.8 per cent to a low of 1.6 per cent, with an average of 2.4 per cent. For next year, 2002, the economists expect a rebound, with forecasts ranging from growth of 2.5 per cent to 4 per cent, with an average of 3.4 per cent.

The question is: What do these forecasts mean for the finances of the nation? Specifically, what do they mean for our projections of balanced budgets? For the tax cuts promised in Budget 2000 and in the October Statement? For the Health Accord reached with the provinces and territories last year?

Let me begin by reminding you of the situation at the time of the October Statement and what we had projected for each of the next two years.

In October, after funding our tax cuts and expenditures such as the Health Accord, we projected a total surplus of $8.3 billion for 2001-2002. This was made up of $4.3 billion in unallocated surplus – to cover priorities such as those outlined in the Red Book – the $3-billion Contingency Reserve and $1 billion in economic prudence.

Based on the revised average of the private sector forecasts of 2.4-per-cent growth in 2001, offset by lower interest rates and the ongoing impact of higher-than-expected revenues last year, the budgetary balance will decline by $1.1 billion. This leaves a surplus for the current fiscal year of $7.2 billion for prudence, to cover our $3-billion Contingency Reserve and to deal with policy measures, of which $600 million has been committed to date.

For 2002-2003 we projected a total surplus of $7.6 billion. This was made up of $2.6 billion in unallocated surplus, the $3-billion Contingency Reserve and $2 billion in economic prudence. Using the revised average of the private sector forecasts of 3.4-per-cent growth for 2002, and again taking into account similar offsets, the budgetary balance will decline by $300 million. This leaves a surplus for 2002-2003 of $7.3 billion for prudence, the Contingency Reserve and policy measures, of which $400 million has been committed.

Mr. Chairman, let me go one step further. The aforementioned numbers are derived from the average of the total range of private sector forecasts. Let me now use the average of the most pessimistic of the private sector forecasts. Even here – 1.8-per-cent growth in 2001 and 2.9-per-cent growth in 2002 – the net impact would result in an adjusted budgetary surplus of $6.2 billion this year and $5.1 billion next year. In other words, Mr. Chairman, despite the economic slowdown, and even assuming the more pessimistic average private sector forecast, the Health Accord is protected; the $100 billion in tax cuts is protected. And we will not fall back into deficit. This is the payoff for the prudent approach we have adopted from the beginning.

In the past some have suggested that we were being overly cautious. However, we have never assumed that the business cycle had been abolished. We have always believed that it is better to prepare for rain, even in the sunniest of forecasts. Now that clouds have appeared, Canada has not been caught unprepared.

Mr. Chairman, that being said, while our fiscal situation allows us to ride out the current economic slowdown, we are very conscious of the reality that many Canadians are feeling its effects. It is of little comfort to them to hear that the Government is doing fine. They need to know that we have acted – and continue to act – in ways that will benefit them.

Actions Supporting the Canadian Economy

In the February 2000 budget and the October Statement, we outlined a number of actions which are part of our ongoing strategy to protect Canadians, a strategy to invest in the social fabric of our country, reduce taxes and pay down debt. These actions are not only the kind of initiatives that will contribute to the long-term strength of our economy – they also provide stimulus in the short term when we need it now, by putting more money into the hands of Canadians, by spurring business, sparking investment and creating jobs.

First and foremost, there are tax cuts – the largest in Canadian history.

Last October we reduced the tax on capital gains and increased the investment amount for tax-free rollovers. In January we took a second step in creating a new Canadian advantage for investment and job creation. We cut corporate income tax rates by one percentage point, and further cuts – two points in each of the next three years – will bring corporate rates below levels in the U.S. Because these corporate tax cuts are being fully legislated, businesses can – and should – factor them into their investment plans starting immediately.

In terms of personal income taxes, our actions have been even more dramatic. In January of this year we reduced taxes at all income levels – 21 per cent on average – putting more money into the hands of Canadians, especially moderate-income families with children. As well, the earlier reintroduction of indexation increased personal credits and tax brackets so that taxpayers will be forever protected from inflation. And finally, in July a further $900-million stimulus will come with the increase in the Canada Child Tax Benefit, bringing significant help to families with children.

What do all of these tax measures mean for Canadians?

A typical two-earner family of four with a combined income of $60,000 will see its federal taxes drop by $1,000 this year – an 18-per-cent tax cut. A single parent with one child and $25,000 in income is receiving an additional $800 this year, for a total benefit of $2,500. Mr. Chairman, this year alone these tax measures will provide the Canadian economy with $17 billion in added stimulus.

Furthermore, in addition to the tax reductions, which are largely focused on middle- and low-income earners, a number of strategic investments are being made in areas that are also of great importance to Canadians – areas like health care, education and innovation.

As mentioned earlier, last September the federal, provincial and territorial governments signed a five-year Health Accord, to which the Canadian government contributed $21.1 billion. This included $2.2 billion for early childhood development, which will help to ensure that our children get the best possible start in life, arriving at school ready to learn and equipped to succeed. This year, as a result of the Accord, the Canadian government will provide an additional $2.8 billion to the provinces and territories for health, education and children. In addition, $1 billion has just been provided to the provinces and territories to purchase medical equipment, along with $500 million for investments in health information technology and $200 million per year for each of the next four years for the Health Transition Fund, which supports innovation in primary health care reform.

A further $800 million in equalization payments will flow this year as a result of the lifting of the ceiling for 1999-2000. This is in addition to the recently announced $1-billion increase in equalization payments for 2000-2001.

Mr. Chairman, in Budget 2000, we announced a five-year program consisting of $2 billion for infrastructure, particularly in the area of the environment, and $600 million for highways. Because this funding will be provided on a cost-shared basis, it will leverage more than $6 billion for infrastructure and $1.2 billion for highways. These investments

will benefit communities right across Canada. Agreements on the infrastructure portion have now been reached with all of the provinces and two of the three territories. As a result, we expect more than $1 billion in new capital investment this year alone.

One of the most consistent threads that has run through our policies in recent years has been a recognition that innovation is key both to the strength of our economy and to the quality of our lives. Budget 2000 and the October Statement built on that imperative, making large, long-term investments in the knowledge infrastructure of our country – our universities and research institutes. Thus, this year alone $500 million will be injected into the economy through the Canada Foundation for Innovation, Genome Canada and the Atlantic Investment Partnership.

Mr. Chairman, taken together, all of the expenditure initiatives announced in Budget 2000 and the October Statement amount to almost $7 billion in stimulus for the Canadian economy this fiscal year. When combined with the $17 billion in tax measures, the total impact this year alone will be close to $24 billion – this is one of the most, if not the most, stimulative packages introduced into its economy by any government of a major industrialized country this year.

Finally and very significantly, reinforcing these fiscal actions have been the steps taken by the Bank of Canada to lower interest rates. The Bank Rate has fallen by a full percentage point in the last four months alone, providing real relief to Canadian families. One-year mortgage rates, for example, have fallen significantly since last December. This means it is easier for young couples to buy that first home or for families to trade up to a larger one. It means cars and other major items are less expensive to finance and it means lower borrowing costs for those wanting to start or expand their businesses.

Mr. Chairman, so far I have talked about the state of the economy, the impact the current slowdown is having on our finances and some of the measures we are taking to stimulate growth. Looking ahead to the longer term and to the underlying fundamentals of our economy, let me now address two other issues.

First, the anchor of a low interest rate policy is the establishment of a low-inflation regime. The Bank of Canada and the federal government have achieved success in this respect through three-year agreements on inflation targets. The existing agreement is due to expire this year. To maintain low inflation, lower interest rates and continued growth, I am pleased to announce today that we have agreed with the Bank of Canada not only to extend the current agreement on inflation targets, but to do so for five years. That means our target range for inflation will remain between 1 per cent and 3 per cent. Maintaining these targets will allow markets and investors to plan with confidence, knowing that Canada will remain a low-inflation environment.

Second, in terms of the national debt, Canada has reduced its federal debt-to-GDP ratio from a peak of 71 per cent in 1995-1996 to below 53 per cent at the end of last year. In recent years no country has reduced this ratio as much as Canada. Furthermore, in absolute terms, we have paid down the federal debt at an unparalleled pace. When times are slow, the rate of debt reduction will naturally slow, but when times are good – as they were last year – we should take advantage of that fact to reduce the burden on future generations.

In the October Statement, the Government committed to paying down at least $10 billion of debt. Because our revenues were higher than expected, I am pleased to announce today that we will do better than that. We now expect to pay down at least $15 billion of debt for the year just ended. This means that we will have retired more than $33 billion of debt in the last four years – $27 billion in the last two years alone – saving Canadians close to $2 billion a year in interest payments – money that can be used for other priorities such as health care and education, year in and year out.

Conclusion

Mr. Chairman, let me just say in closing, that the global economy is slowing is clear. Our job is to enable Canadians to ride through the downturns and to take advantage of the upturns. Therefore, we will continue to report to Canadians on the trends. And let there be no doubt, we will remain vigilant.

However, there are those who say that to counter the slowdown now we should cut taxes more or that we should spend more. In other words, that we should take the chance of going back into deficit. Well, that we will not do. We will not put at risk all that Canadians have worked so hard to achieve over the past few years. Rather, we will maintain the approach that has seen us through the peso crisis of 1994 and the Asian crisis of 1997, and which will see us through the current slowdown.

Looking ahead, our long-term plan means we will continue to cut taxes, it means we will continue to cut debt and it means we will continue to control spending. But as well, it means we will never forget that in the knowledge economy, the real engine of growth is the human mind, and that how we equip our people today – to learn, to invent, to create – will determine this nation's ability to produce jobs, to generate growth, raise living standards and provide opportunity tomorrow. For this reason, we must continue to invest in education and innovation. We must overcome the shortage of skilled workers across the economy and help those who have difficulty with the transition, never forgetting that the society we build is just as important as the economy we create.

That is why, Mr. Chairman, when challenges come, we must keep our eyes fixed on the purposes we have set and remind ourselves not only of what we have already done but, above all, of what we can do together.

Annex 1

Recent Economic Developments and Outlook[1]

[1] Incorporates data available up to May 11, 2001.

Highlights

- *The Canadian economy enjoyed a strong economic performance over the past four years: gross domestic product (GDP) growth averaged 4¼ per cent, over 1.5 million jobs were created, the unemployment rate fell significantly to 6.8 per cent in 2000, productivity growth improved, and real per capita personal disposable income rose 2.9 per cent last year.*

- *In late 2000, however, the global outlook began to weaken, led by a sharp slowdown in growth in the United States.*

- *The U.S. manufacturing sector has been hit hardest, particularly in the automotive sector and in information and communications technologies industries. As confidence and equity markets declined, U.S. growth forecasts for 2001 have been revised down from 3.5 per cent in September 2000 to 2 per cent in May 2001.*

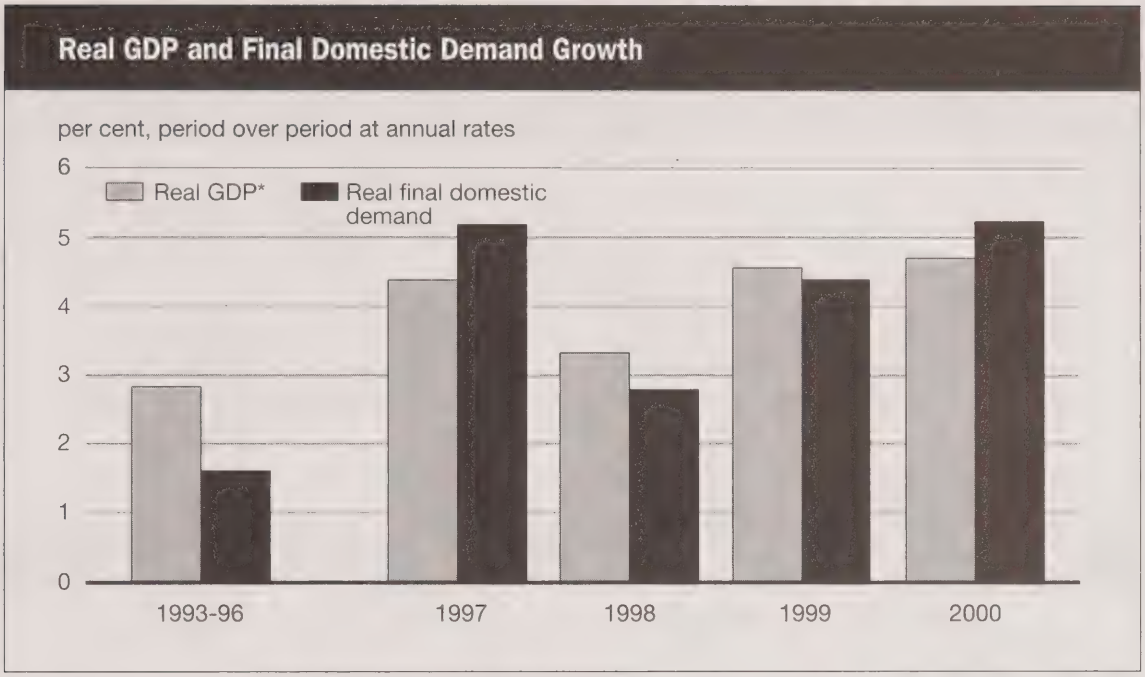
- *As a result of Canada's strong economic links with the U.S., especially in the manufacturing sectors of the two countries, the slowdown in the U.S. has spilled over into Canada – in particular into the manufacturing industries most affected in the United States.*

- *However, other sectors of the Canadian economy – such as service, energy, construction and aerospace industries – are continuing to grow solidly.*

- *In addition, tax cuts at all levels of government will contribute to growth both this year and next, while declines in interest rates will continue to encourage business investment, housing demand and consumer spending.*

- *Overall, private sector forecasters have lowered their expectations for 2001 growth in Canada from 3.5 per cent at the time of the October 2000* Economic Statement and Budget Update *to 2.4 per cent in the March 2001 private sector survey. Expected growth in 2002 is now 3.4 per cent, up slightly from the October Statement.*

The Canadian economy has grown strongly in recent years



* These numbers could change due to methodological revisions by Statistics Canada that will be incorporated in the May 31 National Income and Expenditure Accounts release (see page 44 for details).

- Since the Canadian economic turnaround began in earnest in 1996, Canada has enjoyed strong real GDP growth averaging 4¼ per cent compared with just 2.8 per cent over the previous four years. Indeed, in the fourth quarter of 2000, real GDP advanced for the 22nd consecutive quarter.

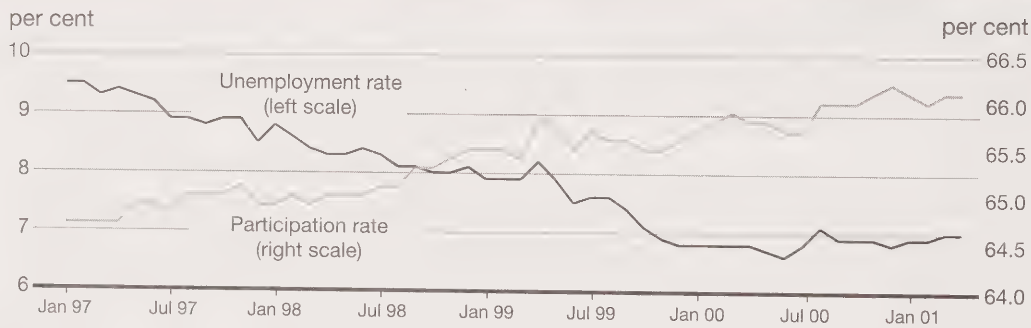
- Since 1996 growth has been well balanced between robust foreign demand – particularly from the United States – and a strong expansion of domestic demand.

Strong labour market performance since 1996

Total Employment and Full-Time Employment*

* Incorporates data to April 2001.

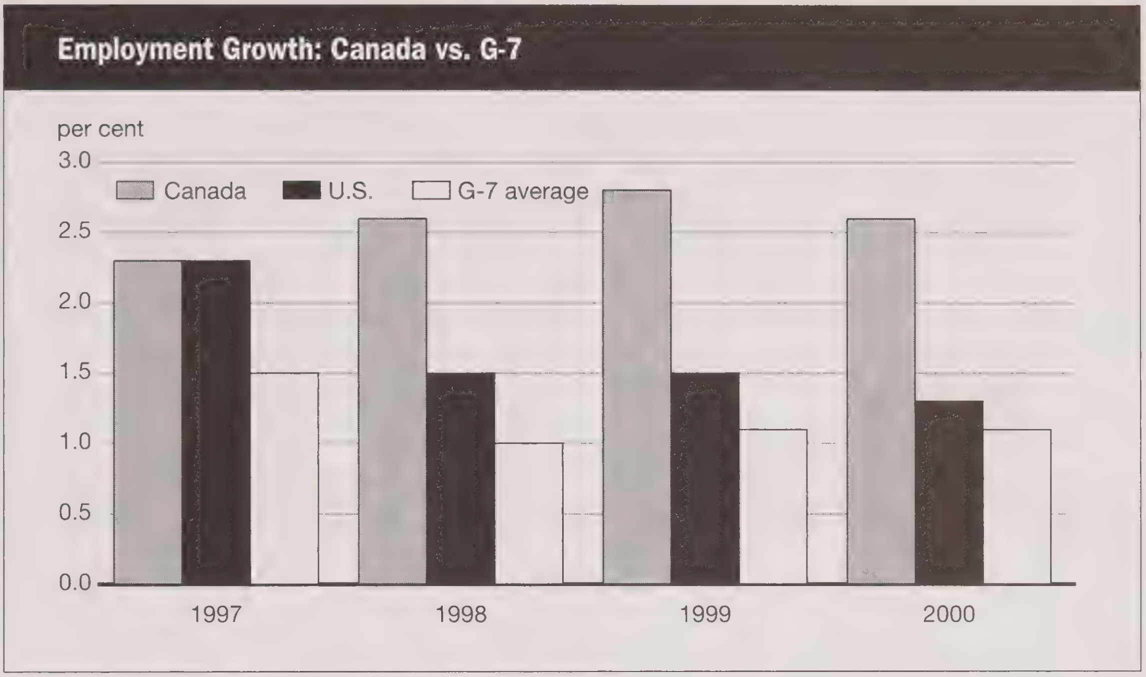
Unemployment and Participation Rates*



* Incorporates data to April 2001.

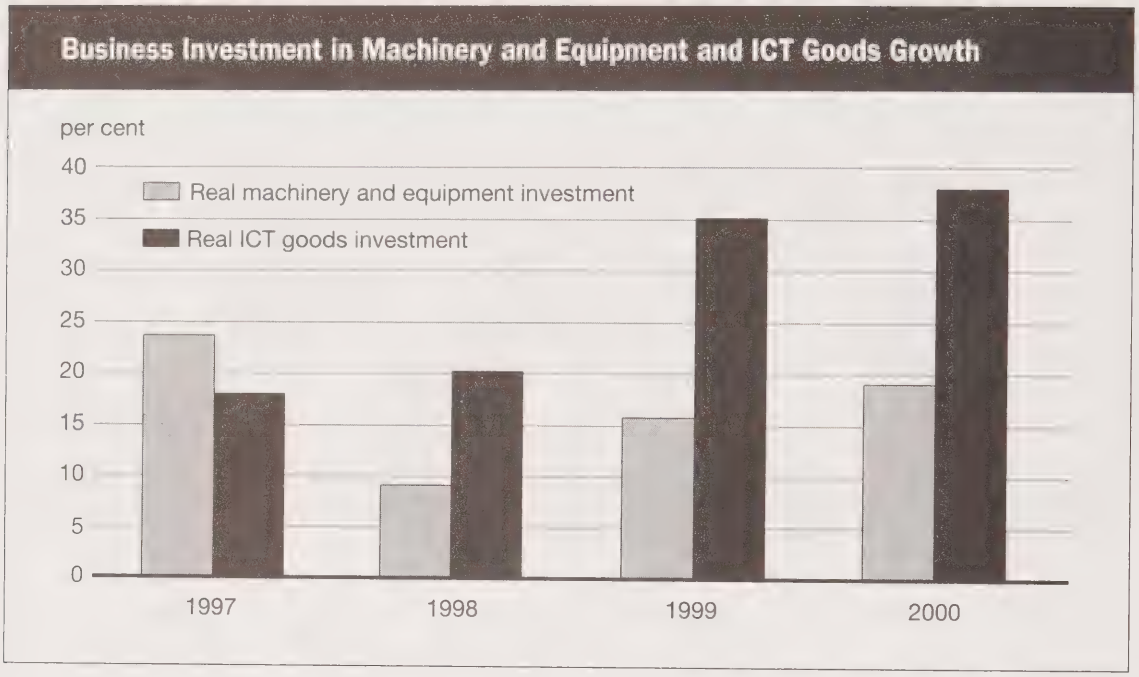
- Since the end of 1996 sustained demand growth has generated a marked improvement in labour market conditions.
- Over this period the Canadian economy has generated over 1.5 million jobs, virtually all of which have been full-time. In the last 12 months alone 240,000 new jobs have been created.
- The unemployment rate has dropped sharply from 9.5 per cent at the beginning of 1997 to an average of 6.8 per cent in 2000.
- Improved employment prospects prompted a resurgence in labour market participation, which rose to its highest level in nine years at the end of 2000.
- After a pause in January and February of 2001, employment growth resumed in March and April, with a total of 55,000 jobs created.

Canada has led the Group of Seven (G-7) in employment growth for four consecutive years



- Since 1996 Canada had the best job creation rate of any G-7 country.
- Over that period employment growth in Canada was more than double the G-7 average and over 1.5 times the rate of employment growth in the United States.

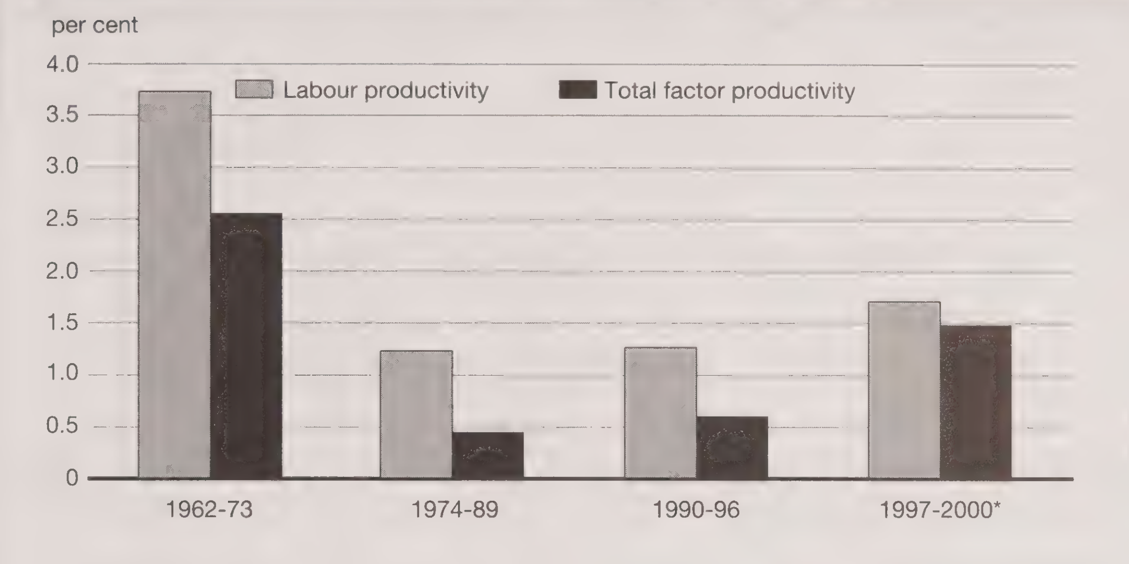
Growth has been boosted by surging business investment in information and communications technology (ICT) goods



- Since 1996 a significant force behind Canada's strong economic performance has been business investment in ICT goods.
- Over this period business investment in these areas has averaged growth of 27.4 per cent, over four times the rate of growth of all other business investment and over six times the rate of growth of the overall economy.

Our productivity performance is beginning to improve

Business Sector Labour and Total Factor Productivity Growth



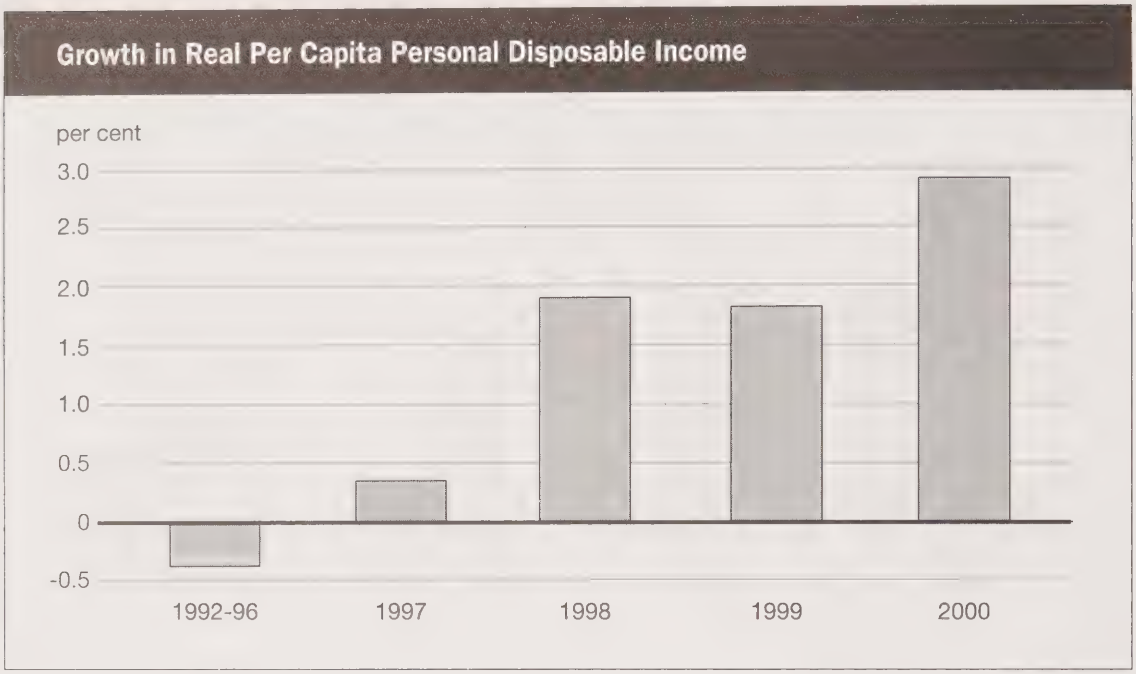
* 1997-99 for total factor productivity.

- Strong growth in business investment is translating into a noticeable improvement in our productivity performance.

- Since 1996 growth in business sector labour productivity (output per hour) has begun to increase, advancing to 1.7 per cent annually compared to 1.2 per cent annually over the previous two decades.

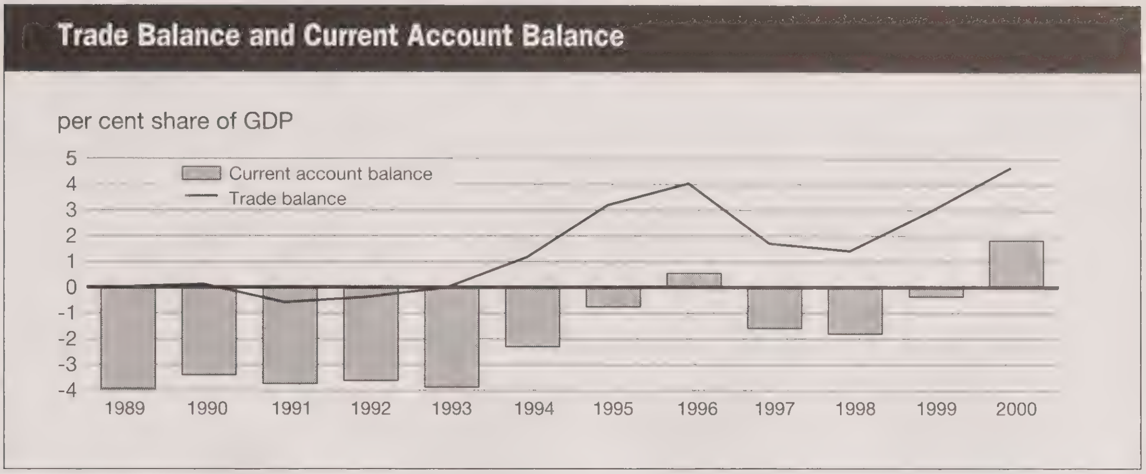
- Total factor productivity growth, which accounts for the productivity of both labour and capital, has improved even more over the past four years, growing by 1.5 per cent annually compared with 0.4 per cent annually over the previous two decades.

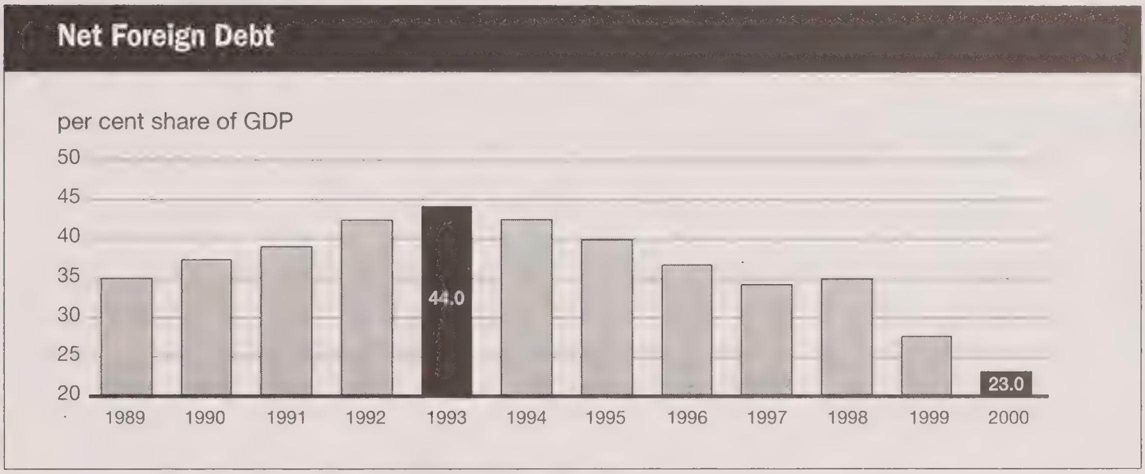
Improved employment and productivity growth are leading to higher real incomes



- Strong employment growth, combined with the recent pickup in our productivity performance, has led to improved growth in real per capita personal disposable income – an important indicator of living standards.
- From 1992 to 1996 weak employment and productivity growth caused real per capita personal disposable income to fall by an average of 0.4 per cent per year.
- Since 1996 strong growth in employment and improved productivity growth have meant that real per capita personal disposable income growth has averaged 1.7 per cent.
- In 2000 real per capita personal disposable income enjoyed its strongest annual growth since the late 1980s, rising 2.9 per cent.

Canada's trade, current account and international investment positions are much improved



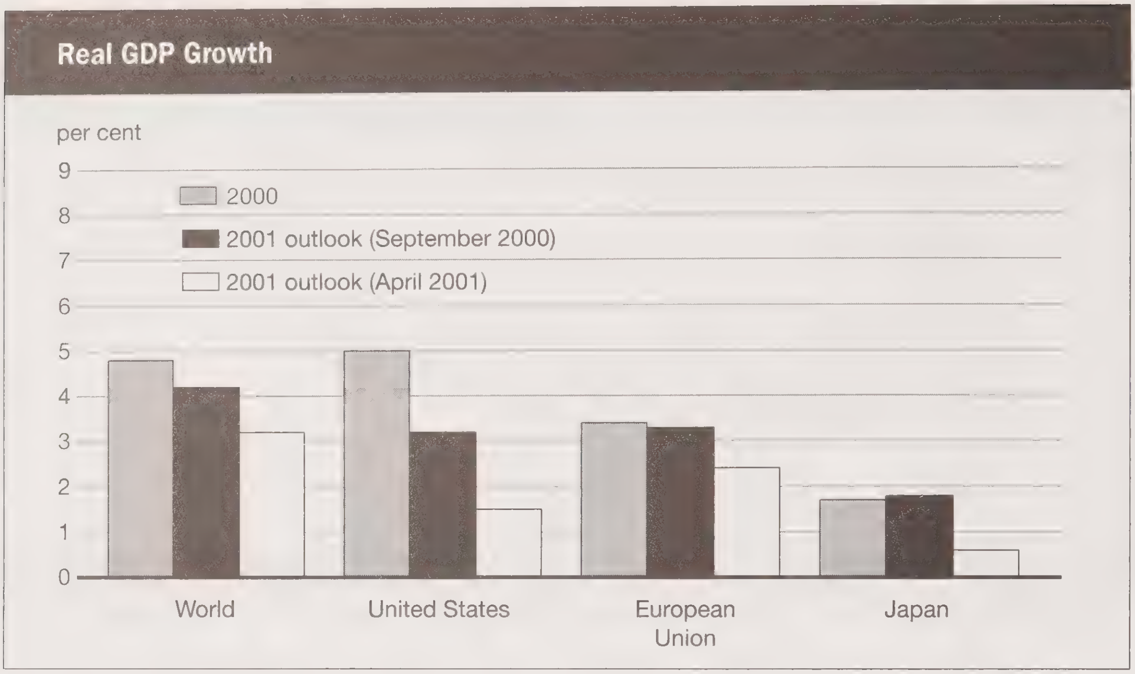


- Strong growth in exports, particularly to the United States, has meant that Canada now enjoys its most favourable trade balance and current account balance on record. In 2000 our current account balance rose to a record $18.9 billion surplus (or 1.8 per cent of GDP) – a sharp contrast to the record high current account deficit of close to $28 billion (or 3.9 per cent of GDP) in 1993.

- The elimination of our current account deficit has pushed Canada's net foreign debt as a share of GDP down to its lowest level since the 1950s. Since 1993 Canada's net debt to foreigners has dropped from 44 per cent of GDP to just 23 per cent in 2000.

- This benefits us by reducing our net investment income flows to foreigners and lowering our exposure to global financial market shocks.

Recently the global economic environment has weakened ...



Source: International Monetary Fund, *World Economic Outlook*, September 2000 and April 2001.

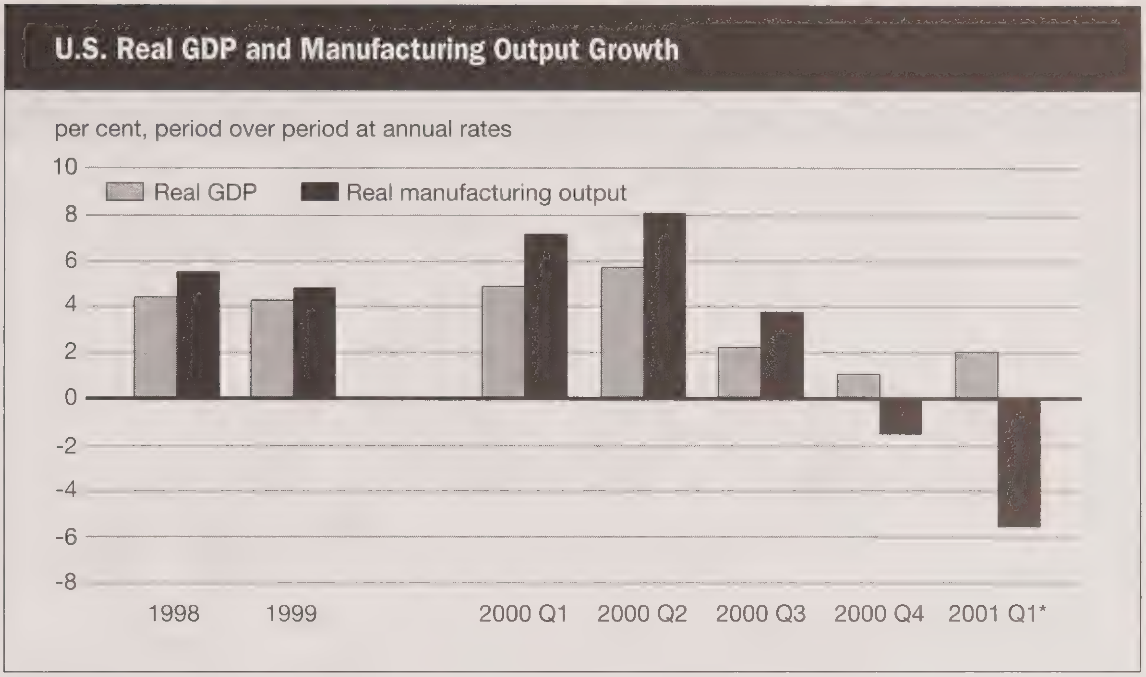
- The outlook for global economic growth this year has weakened, from 4.2 per cent at the time of the October 2000 *Economic Statement and Budget Update* to 3.2 per cent by April 2001, led by a deceleration in economic activity in the United States. While forecasters expect this slowdown to be relatively short-lived, downside risks to global growth have clearly increased.

- While the European Union is expected to record a better performance than the United States this year, growth for the European Union is expected to slow to a below-potential pace as well, providing no offset to the impact of slower U.S. growth on the global economy.

- Ongoing structural problems in the Japanese financial system continue to pose a barrier to economic recovery in that country. And, with weaker global demand conditions, growth in the Japanese economy is expected to remain very weak in 2001.

- Slower growth in advanced economies is expected to contribute to weaker growth prospects for developing economies in Asia and Latin America.

… led by a sharp slowdown in the U.S. economy

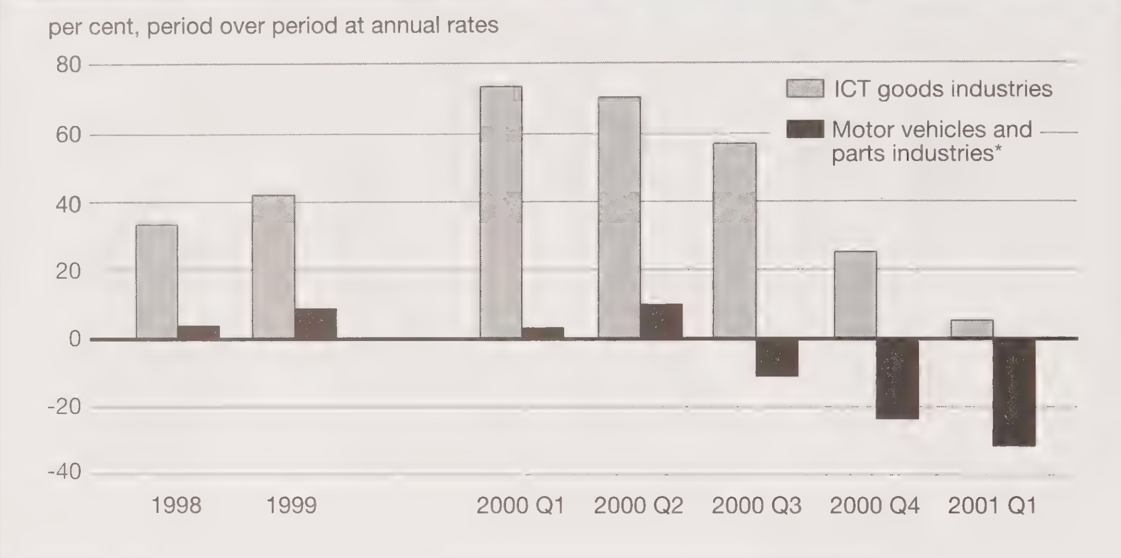


* Advance estimate for real GDP growth.

- While weakening global demand has obvious implications for the outlook for the Canadian economy, what is most significant is the performance of our most important trading partner, the United States.
- In the second half of 2000, a sharp slowdown in demand for U.S. manufactured goods led to a buildup in manufacturing inventories.
- In response, U.S. manufacturers pared output growth by half in the third quarter of 2000, and reduced output in the fourth quarter of 2000 and first quarter of 2001.
- As a result, overall U.S. economic growth slowed from an average of 5.2 per cent in the first half of 2000 to an average of 1.6 per cent over the final two quarters of the year, before recovering modestly to 2.0 per cent in the first quarter of 2001.

Much of the weakness has been focused in the information and communications technologies and automotive industries

U.S. Industrial Production Growth of ICT Goods and Auto Sectors



* Includes wholesale and retail components.

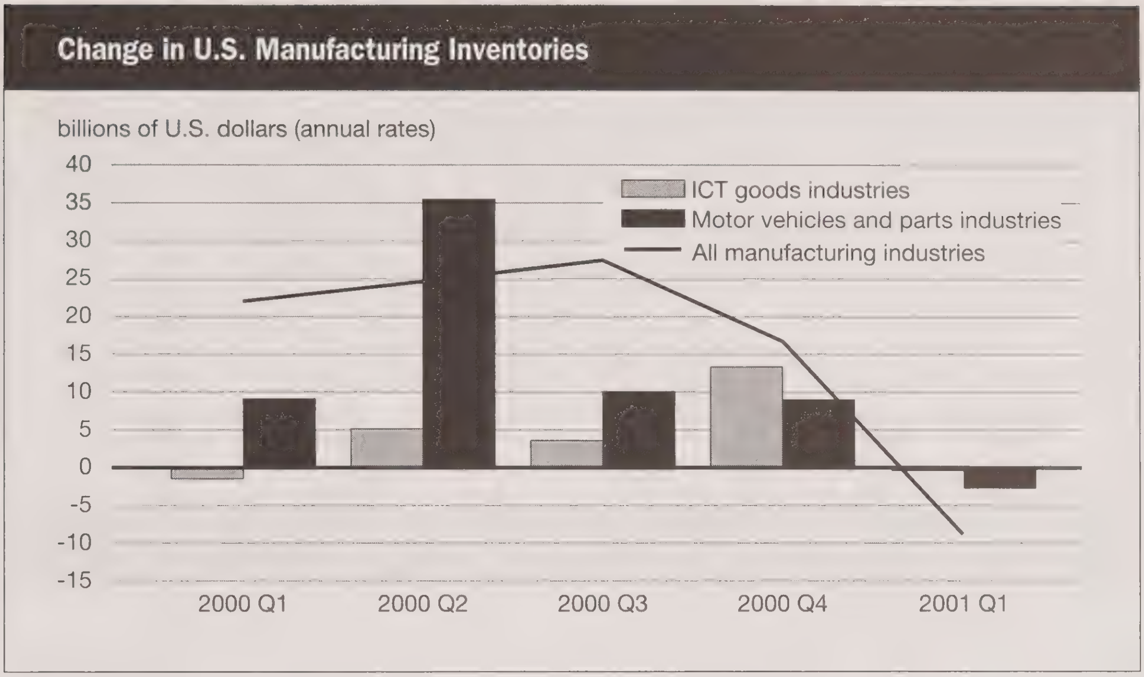
- Within the U.S. manufacturing sector, the sharpest declines were seen in the automotive and ICT goods industries.

- Following a period of very robust growth, sales of new motor vehicles began to ease in the U.S. in early 2000. However, intense competition for market share within the sector led manufacturers to extend incentive programs and sustain high levels of production, despite falling demand. As a result, inventory levels began to rise and production had to be curtailed sharply beginning in the second half of 2000.

- Output of the ICT goods industries grew a very strong 66.8 per cent on average over the first three quarters of 2000, fuelled by rapid growth in business investment in high technology. These industries account for 8.5 per cent of U.S. industrial output, compared with 5.7 per cent for the motor vehicles and parts industry.

- However, as business confidence was shaken by volatility in equity markets, demand fell sharply in the following two quarters. As a result, output growth of the ICT goods industries fell to 25.2 per cent in the final quarter of 2000, and declined further to 5.1 per cent in the first quarter of 2001 – declines which contributed significantly to the overall slowdown in U.S. economic growth.

U.S. manufacturing inventory correction underway

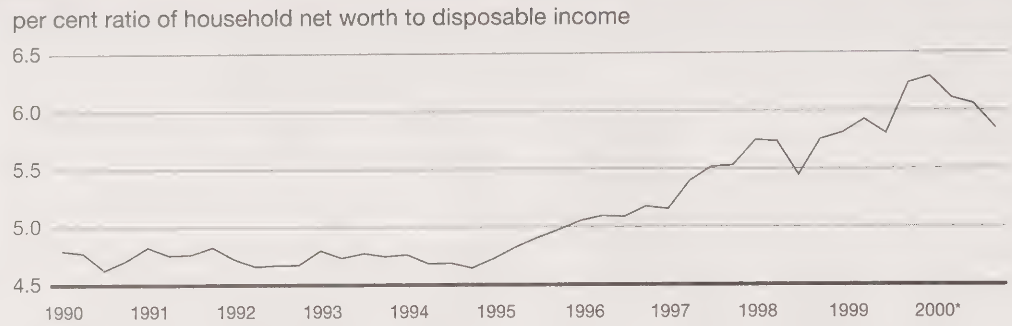


- The delayed response by automotive manufacturers to the slowdown in demand for new vehicles in the United States left a considerable buildup in inventories in mid-2000, which led to large declines in production. Declining inventories this year have removed much of this overhang in the automotive sector.

- Inventory accumulation in the ICT goods industries also increased in late 2000, reflecting a carry-over from the very strong output growth in previous quarters and expectations that the downturn in demand would be relatively short-lived. Some correction is also apparent in those industries thus far in 2001.

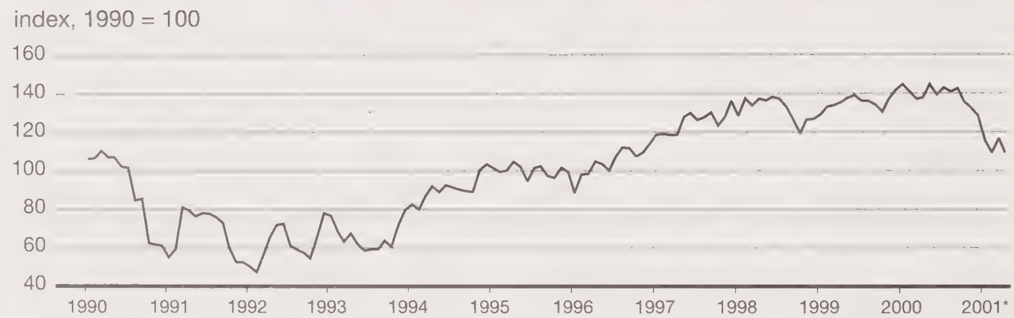
The U.S. slowdown has affected household wealth and confidence

U.S. Household Net Worth to Disposable Income



* Last data point: 2000 Q4.

U.S. Conference Board Consumer Confidence Index



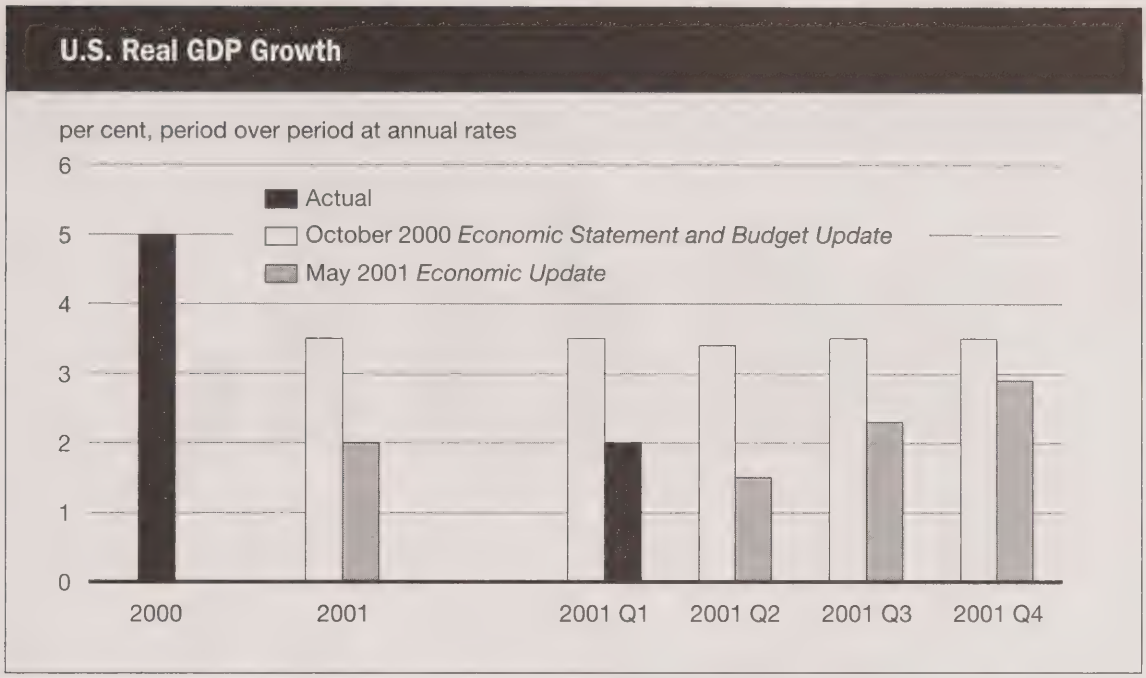
* Last data point: April 2001.

- The rapid run-up in equity prices from the mid-1990s through early 2000 was partly reversed by the "dot.com" correction, creating large-scale volatility in equity markets and reducing stock valuations within the ICT sector. As uncertainty rose through the course of the year, equity prices in other sectors were increasingly affected, and by early 2001 most sectors had witnessed declines in stock market prices from their levels at the beginning of 2000.

- Declines in market valuation have meant that the ratio of U.S. household net worth to personal disposable income declined in 2000 for the first time since 1994. It should be noted, however, that the decline in 2000 only partly unwound the very strong gains enjoyed over the previous five years. For example, in the fourth quarter of 2000, the ratio of net worth to disposable income was close to its average level in 1999, and remained over 20 per cent above its level in 1995.

- Nevertheless, growing uncertainty over future economic conditions and declines in stock market wealth have translated into a sharp decline in consumer confidence in the United States in late 2000 and into early 2001. There is a risk that this could be exacerbated by recent employment weakness (employment fell by 223,000 in April).

Forecasters have lowered their growth outlook for the U.S.



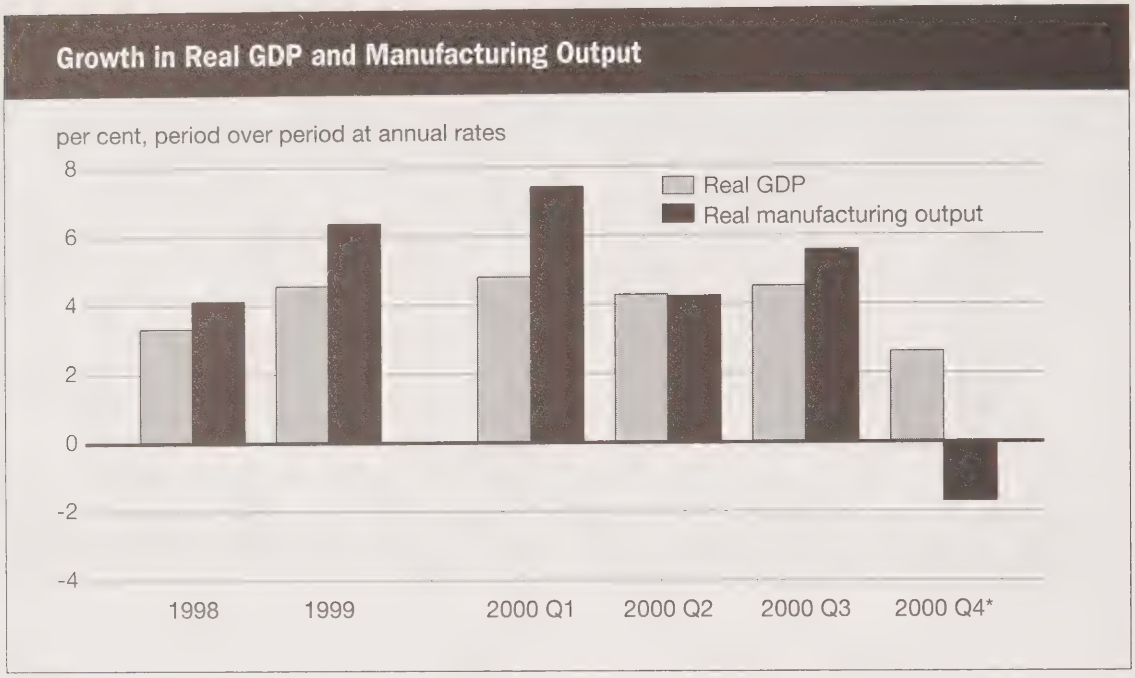
Source: *Blue Chip Economic Indicators,* September 2000 and May 2001.

- At the time of the October 2000 *Economic Statement and Budget Update*, private sector economists believed that growth in the U.S. would slow from 5.0 per cent in 2000 to 3.5 per cent in 2001 – a more sustainable, yet still robust, pace.

- However, the recent declines in U.S. manufacturing output and consumer and business confidence have led private sector forecasters to reduce their expectations of U.S. growth for 2001.

- By May 2001 the average private sector forecast for real U.S. GDP growth had fallen to 2.0 per cent, with weakness concentrated in the first half of the year. However, forecasters expect growth to pick up to close to 3 per cent by the final quarter of 2001.

The Canadian economy has been affected, mostly in manufacturing

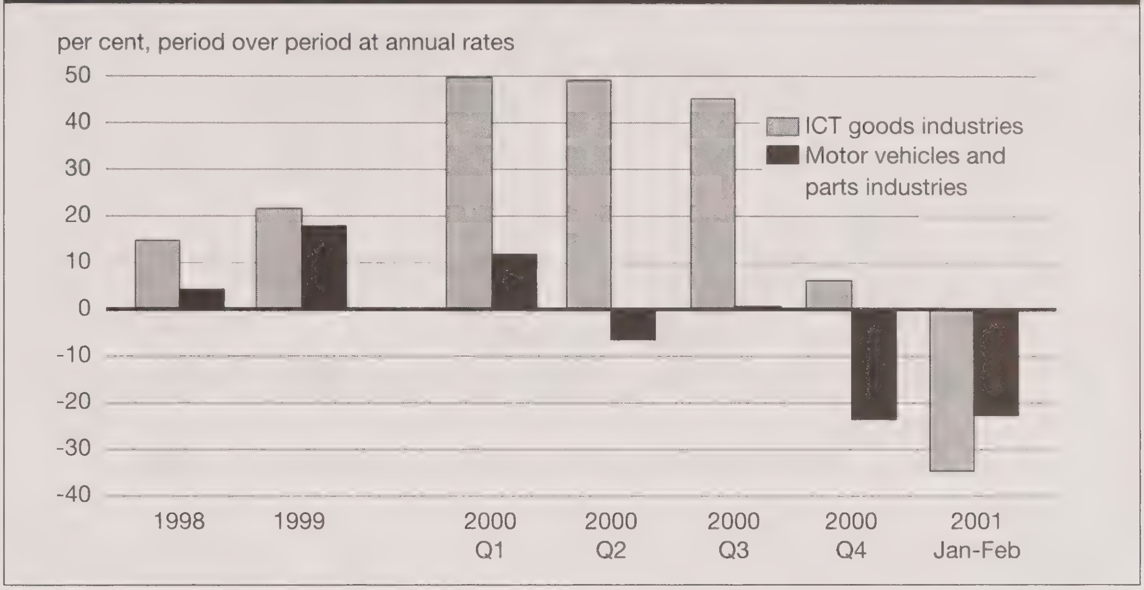


* Real GDP for 2001 Q1 will not be available until May 31.

- Given Canada's strong trade links with the U.S. and the close ties between the manufacturing sectors of the two economies, the slowdown in the United States has spilled over into Canada.
- After averaging 4.5 per cent in the first three quarters of 2000, real GDP growth in Canada slowed to 2.6 per cent in the fourth quarter of the year, led by a 1.7-per-cent contraction in real manufacturing output.

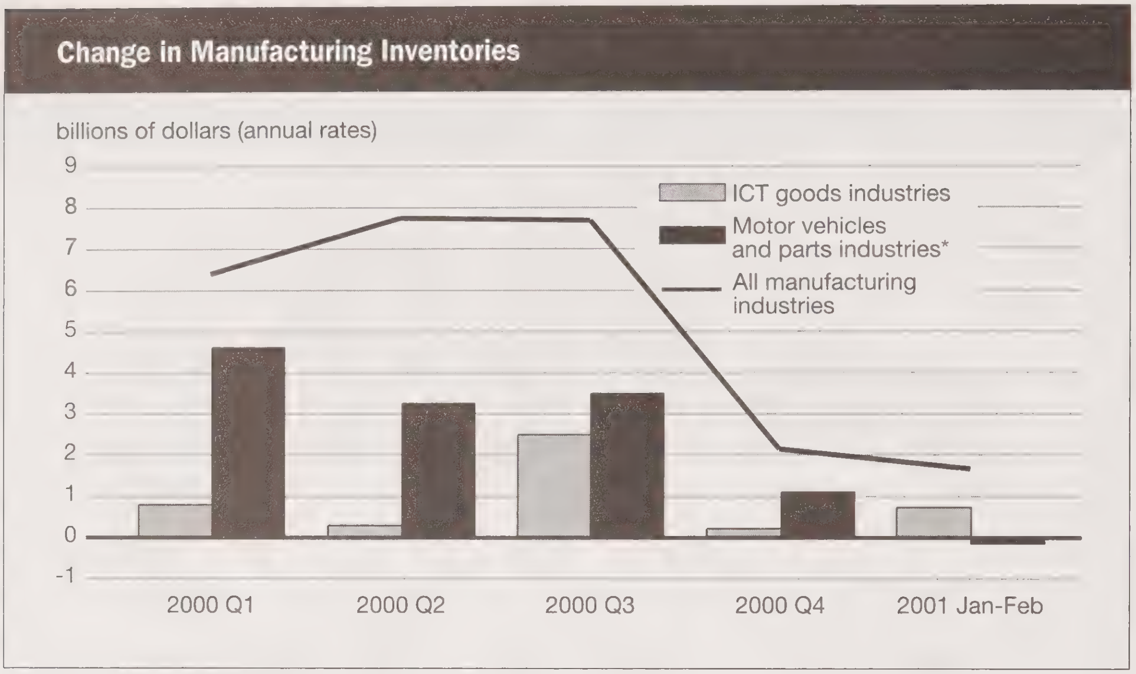
Most export-oriented manufacturing industries in Canada are experiencing weaker demand

Output of ICT Goods and Automotive Industries



- As has been the case in the United States, the output of automotive industries as well as the ICT sector has been hit hardest – not surprisingly, as the majority of Canadian ICT and automotive output is destined for U.S. markets.
- Although these two sectors together accounted for only 5 per cent of total output and 25 per cent of manufacturing output, they were responsible for one-fifth of total output growth in the first three quarters of 2000.
- The strong international linkages in these industries imply that slower demand from the U.S. for these commodities has impacted not only on manufacturing output, but on trade between Canada and the U.S. as well.

Inventory accumulation has slowed dramatically

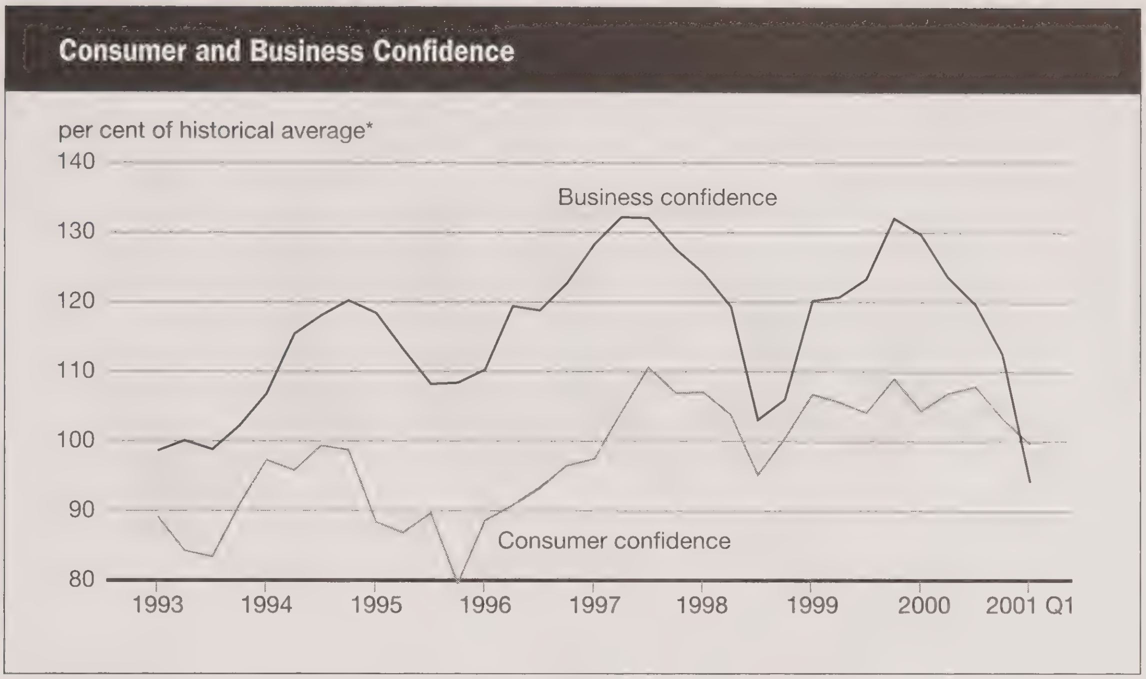


* Includes wholesale and retail components.

- Slowing demand from the United States also contributed to a rise in inventories in Canada. In response, Canadian manufacturers have sharply reduced the pace of inventory accumulation at the end of 2000 and in early 2001, particularly in the automotive and ICT industries.

- This suggests that the realignment between output and demand growth required for a subsequent output growth recovery is underway.

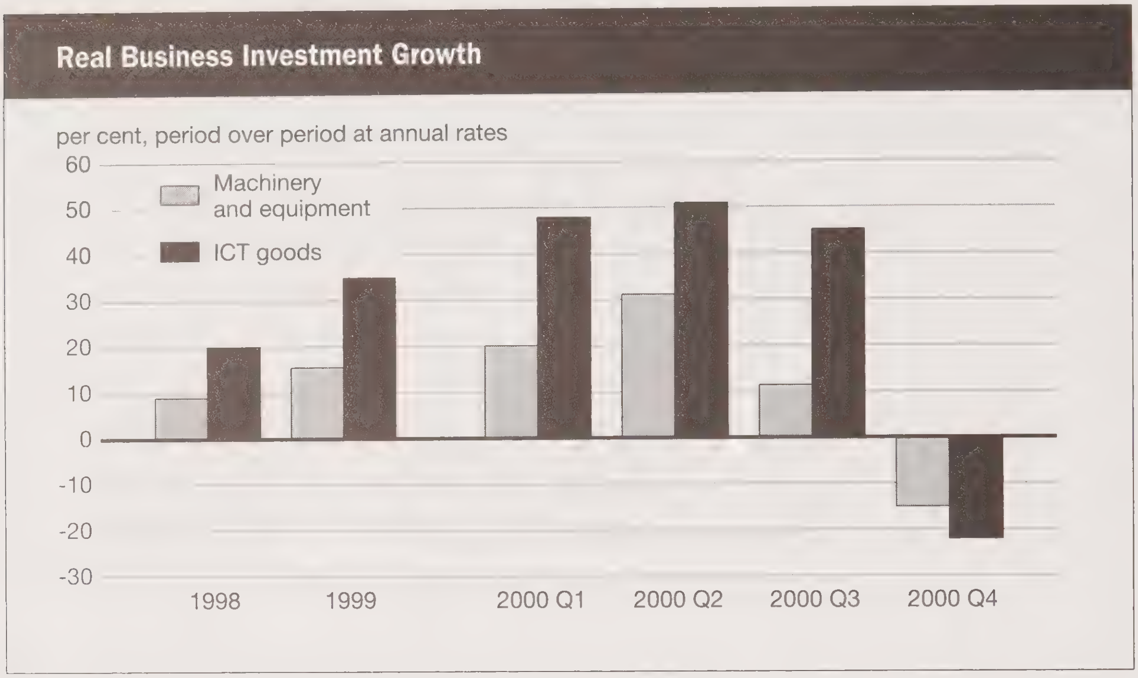
Both consumer and business confidence have declined



* Consumer confidence: 1972 Q1 to 2001 Q1. Business confidence: 1977 Q1 to 2001 Q1.
Source: The Conference Board of Canada.

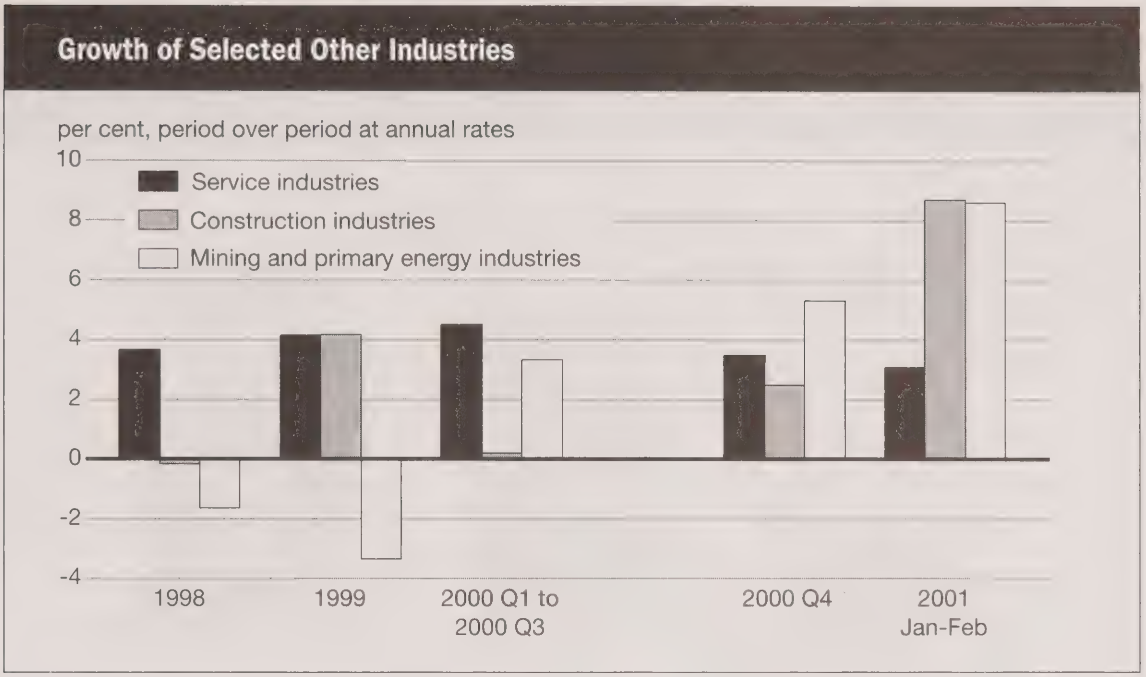
- Rising uncertainty over demand conditions in our largest trading partner, in combination with volatility in financial markets, has impacted on measures of confidence in Canada.
- This has been particularly evident in business confidence, which has declined sharply since early 2000 in tandem with declines in equity markets. For example, the Conference Board of Canada's Index of Business Confidence has declined 27.5 per cent since the first quarter of 2000. As well, Statistics Canada's Quarterly Business Conditions Survey showed a sharp decline in confidence in manufacturing industries in its January 2001 survey, which was followed by a partial rebound in the April survey.
- However, the declines in these measures of business confidence largely reflect the impact of weaker foreign demand faced by larger manufacturing firms. This was illustrated by a recently released survey by the Canadian Federation of Independent Business, which revealed that small and medium-sized businesses – which are much more dependent on domestic demand conditions – remain confident over their future prospects.
- While consumer confidence has also fallen modestly in recent quarters, it remains close to its historical average and above levels seen during the Mexican peso crisis of 1994 and the Asian crisis of 1997.
- This has been demonstrated by the resilience of consumer spending and housing demand thus far in 2001.

Uncertainty has led to slower business investment in Canada



- The declines in business confidence and concerns about slower U.S. demand led firms to curb investment spending in the fourth quarter of 2000.
- In particular, firms cut back on investment in ICT goods – which had grown an astounding 48.0 per cent on average over the previous three quarters.
- This sharp turnaround in high-technology business investment was a substantial contributor to the slowdown in final domestic demand in the final quarter of 2000. And, as a substantial share of these capital goods are imported, this was also reflected in a sharp decline in imports in the quarter.

Positive factors: Growth in other sectors has accelerated



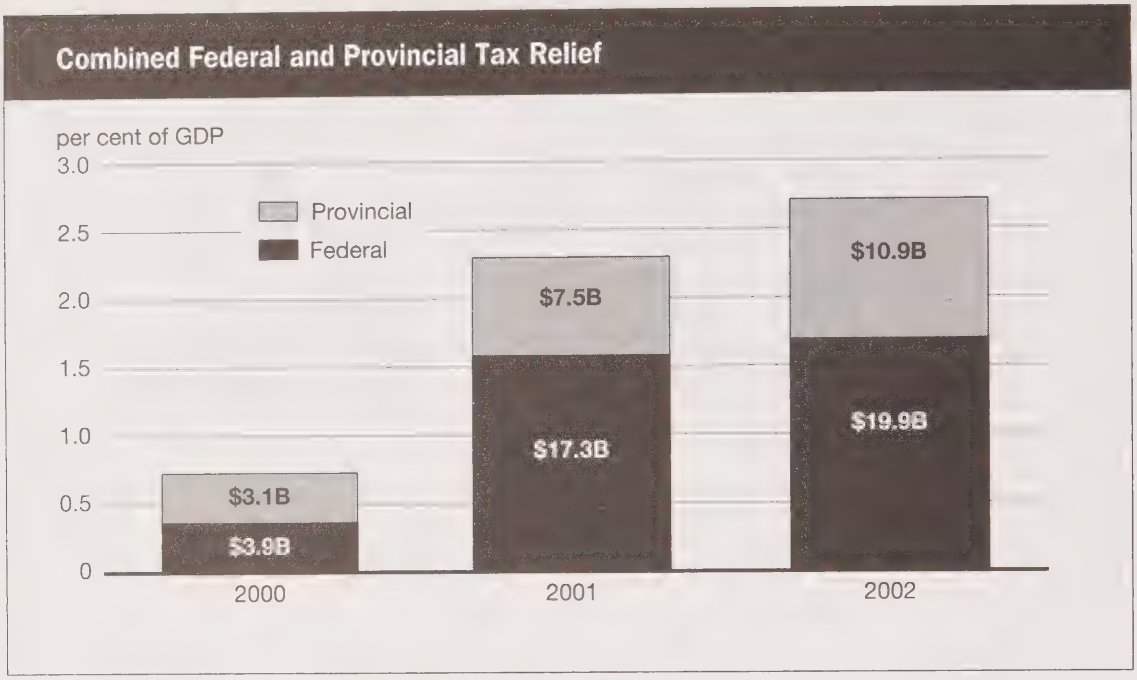
- While it is clear that the slowdown in the U.S. has spilled over into Canada, it is important to note that there are several factors which place Canada in good stead to weather the current economic slowdown.

- Much of the slowdown in Canada has been concentrated in several manufacturing industries, with other sectors experiencing stronger growth in recent quarters.

- Industries such as aerospace and energy have continued to benefit from strong demand for their products, growing by 10.1 per cent and 8.6 per cent respectively thus far in 2001. As well, the continued strength of residential investment has translated into stronger growth in the construction industries (8.7 per cent thus far in 2001).

- Most importantly, growth in service industry output – representing close to two-thirds of total economic activity in Canada – has been very solid. While it has moderated slightly recently, growth remains robust, averaging 3¼ per cent in the final quarter of 2000 and thus far in 2001.

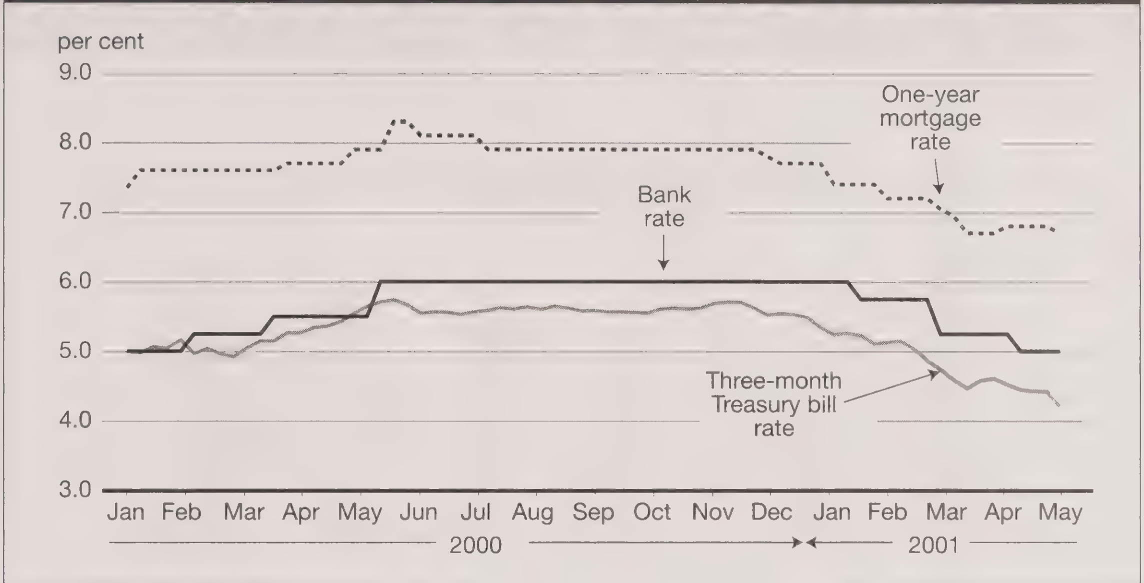
Positive factors: Federal and provincial tax cuts will support economic growth



- Large tax cuts were introduced in the February 2000 budget and the October 2000 *Economic Statement and Budget Update.*
- These federal tax cuts amount to $3.9 billion in 2000, growing rapidly to $17.3 billion in 2001 and $19.9 billion by 2002.
- At the same time, some provinces have also announced tax cuts, amounting to a further $3.1 billion in 2000, $7.5 billion in 2001 and $10.9 billion in 2002.
- Together, tax cuts at all levels of government amount to 0.7 per cent of GDP in 2000, 2.3 per cent of GDP in 2001 and 2.7 per cent of GDP in 2002. This represents a large fiscal stimulus to the economy, especially in 2001.

Positive factors: Declining interest rates

Bank Rate, One-Year Mortgage Rate and Three-Month Treasury Bill Rate*



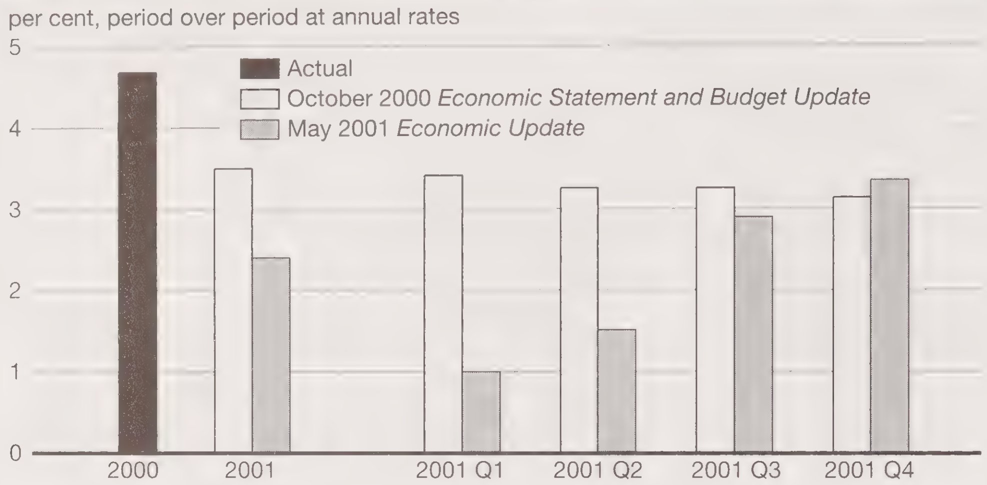
* Incorporates data to May 9, 2001.

- Low and stable inflation has allowed the Bank of Canada to respond to the economic slowdown by reducing the Bank Rate by a full percentage point since the beginning of January. Lower interest rates will provide support to business investment, housing markets and consumer durable expenditure.

- For instance, one-year mortgage interest rates have declined by one percentage point since the end of 2000, which means that a homeowner with a typical one-year mortgage of $100,000 will save about $700 annually.

Forecasters have lowered expectations of Canada's GDP growth for 2001

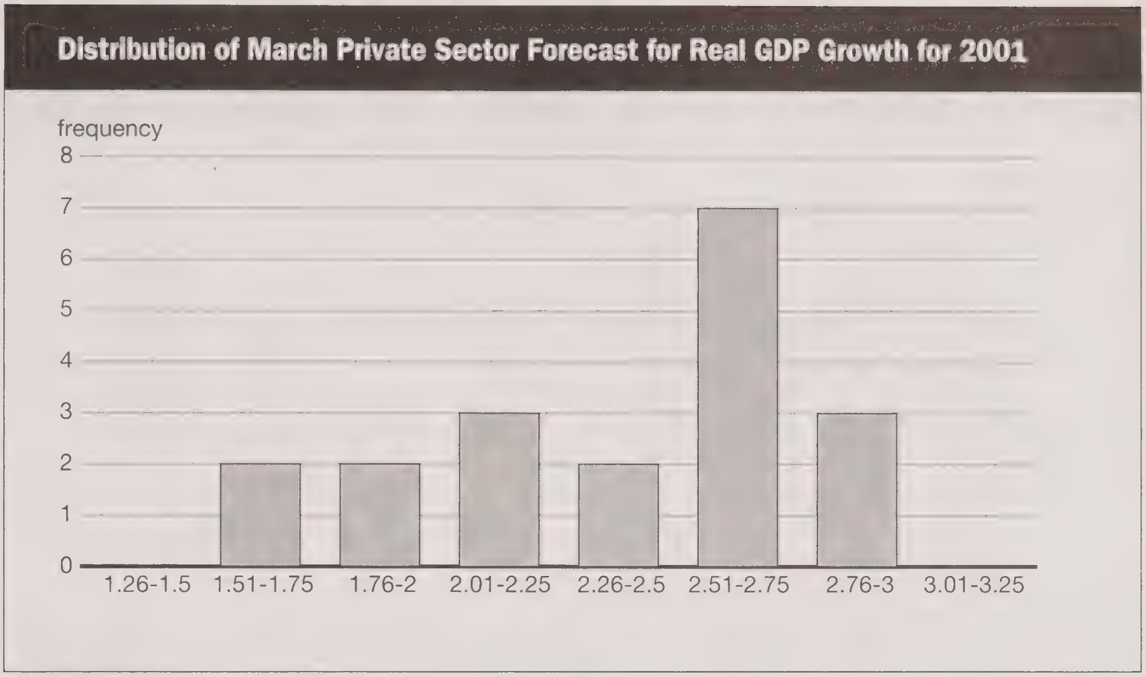
Real GDP Growth



Sources: September 2000 and March 2001 Department of Finance surveys of private sector forecasters.

- Private sector forecasters have lowered their expectations for growth in the Canadian economy in 2001, from 3.5 per cent at the time of the October *Economic Statement and Budget Update* to 2.4 per cent in the most recent survey conducted in March 2001.
- The survey suggests that most private sector forecasters expect the slowdown to be concentrated in the first half of 2001, with growth returning to approximately 3 per cent by year-end and rising to 3.4 per cent in 2002.
- Consumer price index (CPI) inflation is expected to decline modestly this year and next, falling to 2.4 per cent on average in 2001 and 2.0 per cent in 2002, in line with expectations at the time of the October Statement.
- Expectations of lower output growth have been accompanied by private sector forecasts of lower short-term interest rates. At the time of the March survey, private sector forecasters expected short-term rates to remain near current levels in both 2001 and 2002, compared with forecasts of 5.8 per cent and 5.5 per cent, respectively, at the time of the October Statement.

Real GDP growth forecast distribution



Source: March 2001 Department of Finance survey of 19 private sector forecasters.

- The survey also revealed a wide range of forecasts for this year, which underscores the uncertainty in the current economic environment.
- This reflects the increased downside risk to the outlook, in particular if the U.S. recovery is slowed by a retrenchment in consumer spending caused by signs of weakening in the U.S. job market and wealth losses associated with declines in equity prices. In that context, the April U.S. employment decline of 223,000 and accompanying increase in the unemployment rate from 4.3 per cent to 4.5 per cent is a cause for concern.
- The lowest 20 per cent of private sector forecasts averaged real GDP growth of 1.8 per cent for 2001.

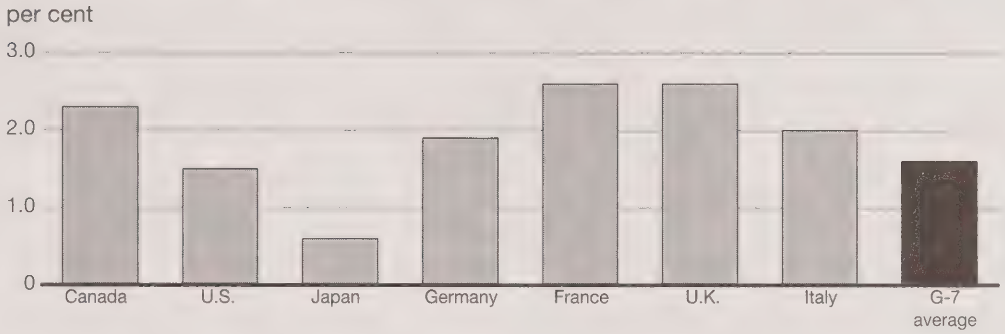
Evolution of the average of private sector forecasts for Canada

	2001	2002
	(per cent)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	2.4	3.4
GDP inflation		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	1.8	1.7
Nominal GDP growth		
October 2000 *Economic Statement and Budget Update*	5.5	4.6
May 2001 *Economic Update*	4.2	5.1
Employment growth		
October 2000 *Economic Statement and Budget Update*	1.8	1.6
May 2001 *Economic Update*	1.3	1.6
Unemployment rate		
October 2000 *Economic Statement and Budget Update*	6.6	6.5
May 2001 *Economic Update*	7.1	6.9
CPI inflation		
October 2000 *Economic Statement and Budget Update*	2.4	2.0
May 2001 *Economic Update*	2.4	2.0
3-month Treasury bill rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.6	4.7
10-year government bond yield		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.3	5.6

Sources: September 2000 and March 2001 Department of Finance surveys of private sector forecasters.

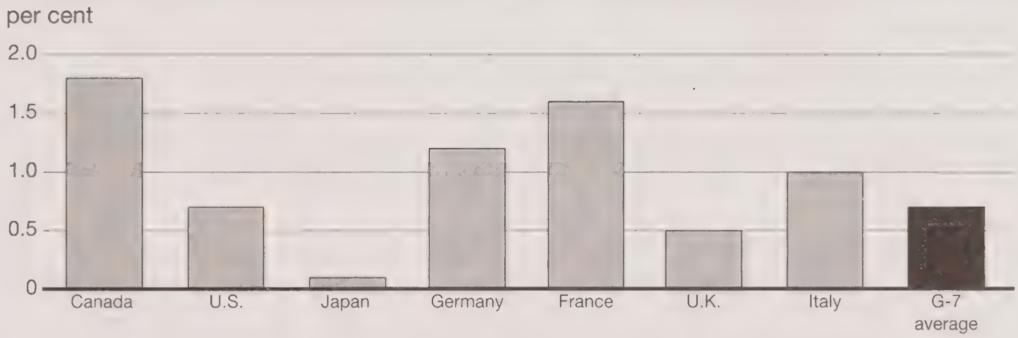
Canada still expected to be above the G-7 average in output growth and lead the G-7 in employment growth in 2001

International Monetary Fund (IMF) Forecast for G-7 Real GDP Growth in 2001



Source: IMF, *World Economic Outlook*, April 2001.

IMF Forecast for G-7 Employment Growth in 2001



Source: IMF, *World Economic Outlook*, April 2001.

- While major international organizations recognize the negative impact of a slowing U.S. economy on Canadian growth, they continue to be positive about Canada's prospects for real GDP and employment growth.
- In its April forecast the IMF expects Canada to outperform the U.S. in terms of real GDP growth, and to be above the average for the G-7, in 2001. Canada is also expected to continue to lead the G-7 countries in employment growth in 2001.

Upcoming Changes in the Measurement of Real GDP

- Statistics Canada will revise its measures of real economic growth with the release of the first-quarter National Income and Expenditure Accounts on May 31. Three changes will occur: the movement to the chain Fisher measure of GDP, the inclusion of software as investment, and a regular historical revision incorporating updated benchmark data.

- The most significant change is the adoption of the chain Fisher index as the official measure of real expenditure-based GDP.

- Real GDP is currently measured using 1992 prices. With the new chain Fisher index formula, real GDP growth will be measured each quarter using weights based on prices from the current and previous quarters.

- The reason for this change is twofold: it produces the most accurate measure of quarter-to-quarter growth in real GDP and its components, and the change brings the Canadian measure in line with the U.S. quarterly National Income and Product Accounts, which also use the chain Fisher formula to measure real GDP.

- In practice, the new measure of real GDP growth will generally be lower than the current measure, particularly in recent years. Growth in 2000, for example, will be restated from 4.7 per cent under the current measure to 4.1 per cent (before historical revision and inclusion of software) under the chain Fisher measure, largely reflecting the lower weight in overall growth of information and communications technology goods in the chain Fisher measure.

- This impact will be particularly noticeable in the fourth quarter of 2000, when real GDP growth under the chain Fisher measure will be 1.4 percentage points lower than under the current measure.

- As growth for 2001 depends on the level of fourth-quarter GDP in 2000, this implies that the measured annual real GDP growth rate for 2001 may also be modestly lower than currently projected by the private sector economists. However, as this impact is purely statistical in nature, it does not affect the underlying outlook for economic growth during the year.

- It is important to note that the chain Fisher measure only affects real variables. This means that the change in methodology will have no impact on nominal GDP, which is the primary determinant of government revenues. As a result, the switch to the new measure will not have implications for the fiscal situation.

- With the May 31 release, Statistics Canada will also change its treatment of business and government investment in computer software. As a result, more software will be considered as investment, which may partially offset the impact of lower chain Fisher growth in some years. Preliminary data suggest that this change will add modestly to real GDP growth in 1999, but will have little impact on real GDP growth in 2000.

Annex 2

Impact of Economic Developments on Canada's Fiscal Prospects

Highlights

- *A budgetary surplus of at least $15 billion is expected for 2000-01, all of which will be used to reduce the national debt. As a result, the debt reduction in 2000-01 will be at least $5 billion more than that committed by the Government in the October 2000* Economic Statement and Budget Update.

- *This surplus in 2000-01 will be the largest since Confederation and the fourth consecutive annual surplus, following surpluses of $3.5 billion in 1997-98, $2.9 billion in 1998-99 and $12.3 billion in 1999-2000.*

- *As a result, net public debt will have declined by at least $33.7 billion over the last four fiscal years, to stand at no higher than $549.5 billion. The reduction in debt results in interest savings of about $2 billion for each and every year.*

- *The debt reduction, coupled with the growth in the economy, has lowered the net debt-to-GDP ratio to below 53 per cent in 2000-01, a drop of over 18 percentage points from its peak of 71.2 per cent in 1995-96.*

- *The current economic uncertainty underscores the importance of the Government's prudent approach to budget planning. This includes making budget decisions on a two-year rolling basis and the inclusion in the budget plans of economic prudence and the Contingency Reserve.*

- *Standard fiscal sensitivity analysis indicates that the changes in the private sector economic forecasts for 2001 and 2002 can be accommodated within the prudence and remaining balance established in the October 2000* Economic Statement and Budget Update.

Table 1
Possible Fiscal Outcome for 2000-01

	($ billions)
October 2000 *Economic Statement and Budget Update*	
Budgetary surplus	11.9
Less: impact of policy decisions since October Statement	
Canada Foundation for Innovation	0.8
Defence	0.6
Agricultural assistance	0.5
Genome Canada	0.1
Other	0.1
Total	2.1
Plus: impact of economic developments	5.2
Net change	3.1
Potential budgetary surplus outcome	15.0

- In the October 2000 *Economic Statement and Budget Update*, a budgetary surplus of $11.9 billion was projected, after accounting for the cost of the Agreements on Health Renewal and Early Childhood Development and other initiatives announced in the Statement. Of this amount, the Government committed to paying down at least $10 billion of debt in 2000-01, leaving a remaining balance of $1.9 billion.

- Since the October Statement, a number of new initiatives have been announced. These include an additional $750 million in funding to the Canada Foundation for Innovation, $624 million to defence, $500 million for agricultural assistance, $140 million to Genome Canada, $34.5 million in incremental funding for merchant marines and $15 million to compensate potato farmers in Prince Edward Island. The fiscal impact of these measures exhausted the remaining balance.

- Based on the monthly results to date, budgetary revenues will be higher than estimated, largely because the tax base and tax yield for 2000 turned out to be higher than estimated at the time of the October Statement, while program spending (excluding the impact of the above policy initiatives) and public debt charges are expected to be somewhat lower. The net impact is expected to increase the budgetary surplus by at least $5 billion.

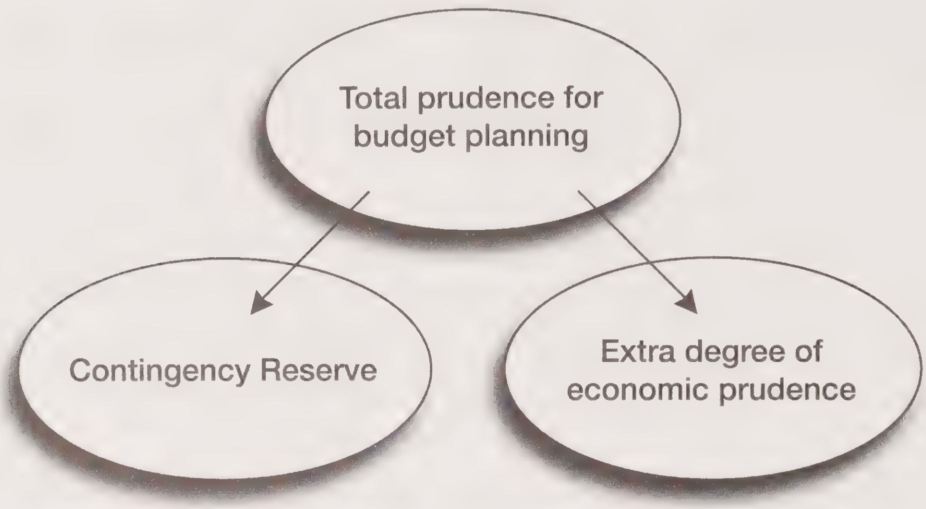
- Some of the better-than-expected outcomes for revenues and public debt charges in 2000-01 can be expected to carry forward into 2001-02 and 2002-03. Although the exact amount will not be known until final audited results are available, it could amount to at least $1 billion in 2001-02 and $750 million in 2002-03. This will provide some offset to the impact of the revised economic outlook on the budgetary balance.

- The fiscal results for the period April 2000 to March 2001 are consistent with the expected surplus for the year as a whole of at least $15 billion (see *The Fiscal Monitor* for March 2001).

Prudence in budget planning

- Since 1993 the Government has followed a prudent approach to budget planning involving a number of important steps.
- The first step relates to the use of private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a regular basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and four leading economic forecasting firms. A key purpose of these consultations is to assess the risks associated with using the average of private sector economic forecasts for budget-planning purposes.
- The second step relates to the use of these economic assumptions to develop status quo fiscal projections.
  - Each fall the four major private sector economic forecasting firms develop detailed fiscal projections for each of the next five years, based on tax and spending policies in place at that time, using the average of the private sector economic forecasts.
- The third step involves including prudence in these fiscal projections for budget-planning purposes.
  - An annual amount of $3 billion is set aside in a Contingency Reserve. The Contingency Reserve is included primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed fiscal forecasts and unpredictable events. The Contingency Reserve also provides a backup against adverse errors in the economic forecast. It is not a source of funding for new policy initiatives. If not needed, it will be used to pay down the public debt.
  - An extra degree of economic prudence is included to provide further assurance against falling back into deficit. The amount is based on an assessment by the private sector economic advisory group of the risks associated with using the average of the private sector economic forecasts. Prior to the 2000 budget this prudence was embedded in the revenue and spending projections, with the result that the exact dollar amount was not explicitly identified, which made it difficult to judge the credibility of the key components of the fiscal projections. For transparency purposes, it has been shown separately since then.

Prudence in budget planning (cont'd)



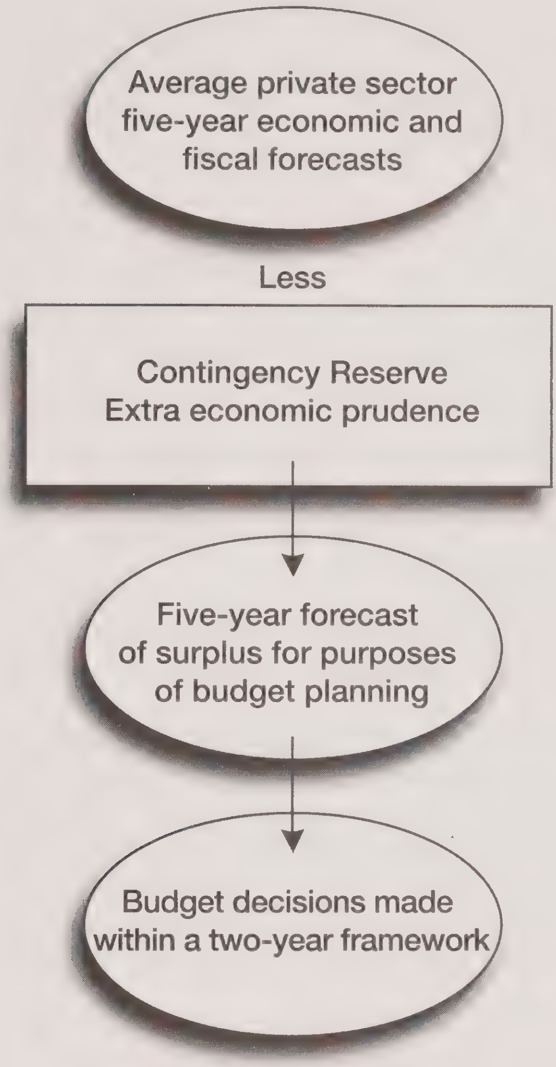
- Finally, in the October 2000 *Economic Statement and Budget Update*, the Government announced that each fall, it would assess the economic circumstances and determine whether a greater amount of debt paydown is warranted for that year.

- It is the view of the private sector economic advisory group that for the purposes of public debate on policy options in the run-up to the annual budget, a five-year time horizon is appropriate. However, it is also the view of the private sector economic advisory group that great caution is warranted in the use of long-term projections as a basis for budget decisions. Therefore, budget decisions continue to be made on a rolling two-year horizon.

- The May 2001 *Economic Update* is an update of the economic forecasts for 2001 and 2002 and their implications for the 2001-02 and 2002-03 budgetary surpluses. To help prepare this Update, the Department of Finance met with the private sector economic advisory group in May 2001.

- This fall, as part of the regular budget preparation cycle for the next budget, the four private sector economic forecasting firms will again be asked to present five-year status quo fiscal projections based on the average private sector economic forecasts available at that time.

Summary: framework for fall update and budget



- In summary, for the purposes of public debate and for budget-planning purposes, the Government will:
  - present in the fall of each year, the average private sector five-year projections of the fiscal surplus, which are based on a common set of economic assumptions;
  - include a $3-billion Contingency Reserve which, if not needed, will be applied to reducing the debt; and
  - include an extra degree of prudence, which will be shown explicitly.
- However, budget decisions are made within a rolling two-year planning horizon, reflecting the difficulties in forecasting economic events over a longer period.
- This approach to budget planning has allowed the Government to better its stated fiscal targets each and every year.

Table 2
Prudence in Budget Planning: October 2000 *Economic Statement and Budget Update*

	2001-02	2002-03
	($ billions)	
October 2000 Statement budgetary surplus (after including costs of initiatives)	8.3	7.6
Prudence		
Contingency Reserve	3.0	3.0
Economic prudence	1.0	2.0
Total	4.0	5.0
Remaining balance	4.3	2.6

- The October 2000 *Economic Statement and Budget Update* forecast a budgetary surplus of $8.3 billion in 2001-02 and $7.6 billion in 2002-03. This was after accounting for the costs of the tax cuts and spending initiatives announced in the October 2000 *Economic Statement and Budget Update.*

- In the October 2000 Statement, the Government committed to balanced budgets or better in both 2001-02 and 2002-03.

- To ensure that these targets would be met, economic prudence was set at $1 billion in 2001-02 and $2 billion in 2002-03, while the Contingency Reserve was set at $3 billion for each year. Thus, the total prudence included in the October 2000 Statement was $4 billion in 2001-02 and $5 billion in 2002-03.

- Taking the projected budgetary surplus and subtracting the prudence, there was a remaining balance of $4.3 billion in 2001-02 and $2.6 billion in 2002-03.

- It was noted in the October 2000 Statement that these remaining balances could be directed to further debt reduction, increased prudence, further tax cuts or increased spending in priority areas.

Table 3
Policy Initiatives Since the October 2000 *Economic Statement and Budget Update*

	2001-02	2002-03
	($ millions)	
Spending initiatives		
Tobacco Control Strategy	70	95
Cultural initiatives	122	189
CBC	60	
Canadian Television Production Fund	100	
Support for Olympic bids/Toronto waterfront	132	125
Government On-Line	120	
Amateur sports	10	10
Organized crime	30	30
Environmental initiatives	79	41
Health commissioner	12	3
Revitalizing Canada's capital	21	58
Total	755	552
Less: Tobacco tax increase	200	200
Net fiscal impact	555	352

Note: Numbers may not add due to rounding.

- Since the October 2000 *Economic Statement and Budget Update*, the Government has announced funding for a number of initiatives. These include the Tobacco Control Strategy, major investments in Canadian culture, support for Olympic bids and amateur sports, incremental funding for Government On-Line, new funding to fight organized crime, investments in a number of environmental initiatives, and funding to launch the Commission on the Future of Health Care in Canada and to revitalize Canada's capital. The total cost of these initiatives amounts to $755 million in 2001-02 and $552 million in 2002-03.

- Offsetting part of this fiscal cost is the increase in tobacco taxes as of April 6, 2001, which is expected to increase federal excise taxes and duties by $200 million per year.

- As a result, the net impact of the policy initiatives announced since the October 2000 *Economic Statement and Budget Update* amounts to $555 million in 2001-02 and $352 million in 2002-03.

Table 4
Sensitivity of Fiscal Outlook to Economic Shocks

	Year 1	Year 2
	($ billions)	
Estimated change in fiscal position from:		
1-per-cent decrease in real GDP growth		
Revenue decrease	1.8	1.9
Expenditure increase	0.5	0.7
Deterioration in budgetary balance	2.4	2.6
1-per-cent decline in inflation		
Revenue decrease	1.9	1.8
Expenditure decrease	0.5	0.5
Deterioration in budgetary balance	1.4	1.3
100-basis-point decrease in interest rates		
Revenue decrease	0.4	0.5
Expenditure decrease	1.1	1.9
Improvement in budgetary balance	0.8	1.4

Note: Numbers may not add due to rounding.

- An indication of the impact of the change in economic assumptions since the October 2000 *Economic Statement and Budget Update* can be derived using standard estimates of the sensitivity of the budgetary balance to changes in key economic variables, such as real gross domestic product (GDP) growth, inflation and interest rates.

- A decrease in the growth of real GDP (through equal reductions in employment and productivity) would lead to lower federal government revenues through a contraction in various tax bases, and an increase in spending, primarily due to higher employment insurance benefits. Using the standard sensitivity analysis, a 1-per-cent decrease in real GDP for one year would lower the budgetary balance by $2.4 billion in the first year and by $2.6 billion in the second year.

- A 1-per-cent reduction in the growth in nominal GDP resulting solely from a one-year decline in the rate of inflation would lower the budgetary balance by $1.4 billion in the first year and $1.3 billion in year two. Most of the impact would be on budgetary revenues, as wages and profits would be lower as well as the price of goods and services subject to sales and excise taxes. The impact on expenditures would be largely reflected in those programs that are indexed to inflation, such as elderly benefit payments.

- A sustained 100-basis-point decline in all interest rates would improve the budgetary balance by $0.8 billion in the first year, rising to $1.4 billion in year two. This improvement comes solely from the reduction in public debt charges, which reduces overall budgetary expenditures. Expenditures would fall by $1.1 billion in the first year and by $1.9 billion in year two, as longer-term debt matures and is refinanced at the lower rates. Dampening this impact are somewhat lower interest earnings on the Government's interest-bearing assets, which are recorded as part of non-tax revenues.

Table 5
Changes in Economic Assumptions Since October 2000 Statement
Private Sector Average

	2001	2002
	(per cent, unless otherwise indicated)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	2.4	3.4
Difference (percentage points)	-1.1	0.4
GDP price		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	1.8	1.7
Difference (percentage points)	-0.2	0.2
90-day interest rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.6	4.7
Difference (percentage points)	-1.2	-0.8
10-year Government of Canada bond rate		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.3	5.6
Difference (percentage points)	-0.6	-0.2

- As shown in Annex 1, private sector forecasters have lowered their economic growth expectations for 2001 by 1.1 percentage points, but raised their outlook for 2002. The GDP price outlook is somewhat lower for 2001 but correspondingly higher for 2002. Short-term interest rates have been revised down by 120 basis in 2001 and 80 basis points in 2002, while long-term rates are 60 and 20 basis points lower, respectively.

Table 6
Impact of Changes in Economic Assumptions on Budgetary Surplus
Private Sector Average

	2001-02	2002-03
	($ billions)	
Impact from changes in:		
Real output	-2.6	-1.9
GDP price	-0.3	0.0
Interest rates	0.8	0.8
Net impact	-2.1	-1.1

- The revised outlook for real GDP growth reduces the budgetary balance by $2.6 billion in 2001-02 and $1.9 billion in 2002-03. Similarly, the revised outlook for inflation lowers the budgetary balance by an additional $0.3 billion in 2001-02. However, the lower outlook for interest rates improves the budgetary balance by $0.8 billion in 2001-02 and $0.8 in 2002-03.

- The net impact, therefore, lowers the budgetary surplus established in the October 2000 *Economic Statement and Budget Update* by $2.1 billion in 2001-02 and $1.1 billion in 2002-03.

Table 7
Changes in Economic Assumptions Since October 2000 Statement
Lower Growth Scenario*

	2001	2002
	(per cent, unless otherwise indicated)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	1.8	2.9
Difference (percentage points)	-1.7	-0.1
GDP price		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	2.0	1.4
Difference (percentage points)	0.0	-0.1
90-day interest rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.4	4.2
Difference (percentage points)	-1.4	-1.3
10-year Government of Canada bond rate		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.2	5.2
Difference (percentage points)	-0.7	-0.6

* Average of four forecasters with the weakest economic growth forecast for 2001.

- As noted in Annex 1, the current survey of private sector economists reveals a wide range of economic forecasts for 2001, which underscores the uncertainty over the current economic environment and its potential fiscal impact.

- An alternative economic scenario was derived by taking the average of the four economic forecasters with the weakest outlook for economic growth for 2001 and assessing its potential impact on the budgetary balance.

- In this lower real GDP growth scenario, real output growth of only 1.8 per cent is assumed for 2001, with a rebound to 2.9 per cent in 2002. In the October 2000 *Economic Statement and Budget Update*, real growth of 3.5 per cent was expected for 2001 and 3.0 per cent for 2002. Inflation is assumed to be virtually unchanged from that assumed in the October 2000 *Economic Statement and Budget Update*. Short-term interest rates are 140 basis points lower in 2001 and 130 basis points lower in 2002 than those assumed in the October 2000 *Economic Statement and Budget Update*, while long-term rates are 70 basis points lower in 2001 and 60 basis points lower in 2002.

Table 8
Impact of Changes in Economic Assumptions on Budgetary Surplus
Lower Growth Scenario

	2001-02	2002-03
	($ billions)	
Impact from changes in:		
Real output	-4.0	-4.7
GDP price	0.0	-0.1
Interest rates	0.9	1.6
Net impact	-3.1	-3.3

Note: Numbers may not add due to rounding.

- The lower outlook for real GDP growth in both 2001 and 2002 reduces the budgetary balance by $4.0 billion in 2001-02 and $4.7 billion in 2002-03. Part of this deterioration is offset by the lower outlook for interest rates – $0.9 billion in 2001-02 and $1.6 in 2002-03.

- The net impact is to reduce the budgetary surplus by $3.1 billion in 2001-02 and $3.3 billion in 2002-03.

Table 9
Change in Budgetary Surplus: Summary

	2001-02	2002-03
	($ billions)	
October 2000 *Economic Statement and Budget Update:* budgetary surplus	8.3	7.6
Carry-forward from better-than-expected 2000-01 outcome	1.0	0.8
Impact of changes in economic assumptions: private sector average	-2.1	-1.1
Adjusted budgetary balance	7.2	7.3
Memorandum item 1		
Adjusted budgetary surplus under lower economic growth scenario	6.2	5.1
Memorandum item 2		
Policy initiatives since October Statement	0.6	0.4

- In summary, the budgetary surplus, after subtracting the fiscal cost of the tax reductions and other policy initiatives announced up to and including those in the October 2000 *Economic Statement and Budget Update*, was $8.3 billion in 2001-02 and $7.6 billion in 2002-03.

- Some of the better-than-expected outcome for 2000-01 is expected to carry forward into 2001-02 and 2002-03, improving the budgetary surplus projections for those years by $1 billion and $750 million, respectively.

- The net fiscal costs of the changes in the private sector economic outlook are estimated to reduce the budgetary surplus by $2.1 billion in 2001-02 and $1.1 billion in 2002-03.

- The net effect of these changes is to reduce the budgetary surplus by $1.1 billion to $7.2 billion in 2001-02 and by $0.3 billion to $7.3 billion in 2002-03.

- Under the lower economic growth scenario, the net impact is to reduce the budgetary surplus by $2.1 billion to $6.2 billion in 2001-02 and by $2.5 billion in 2002-03 to $5.1 billion.

- These adjusted budgetary surpluses are for economic prudence, the Contingency Reserve and to fund policy measures.

- The net cost of new policy initiatives announced since the October 2000 *Economic Statement and Budget Update* is $0.6 billion for 2001-02 and $0.4 billion for 2002-03.

- As a result, under either scenario, the fiscal impact of the changes in the economic forecasts as well as the cost of the new initiatives since the October 2000 *Economic Statement and Budget Update* can be accommodated within the budgetary surpluses set out in the October 2000 *Economic Statement and Budget Update*, without putting at risk the balanced budget targets for 2001-02 and 2002-03.

The Economic and Fiscal Update

October 30, 2002

Canada

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Presentation

by the
Honourable John Manley, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

October 30, 2002
CHECK AGAINST DELIVERY

Introduction

Allow me to thank you, Madam Chair, and all of the members of this committee for inviting me today.

We meet here at one of Canada's great historic landmarks – Pier 21. From 1928 to 1971 more than 1 million immigrants and refugees from all corners of the world passed through these buildings on their way to a new life in Canada.

Their reasons for choosing Canada were as different as the people themselves. Some came fleeing political and religious persecution in their homelands. Others came to escape poverty or the ravages of war to search for new opportunities in a country that promised fertile land, clear skies and freedom from fear. For hundreds of thousands of new Canadians, Pier 21 stood as a symbol of hope – and a starting point for opportunity.

All of them shared a dream – to build a better life in Canada for themselves and their families. It is the same dream that brings succeeding generations of newcomers to our shores every year. It nourishes and enriches our country, because it brings with it not only the traditions of the past, but the spirit, talent and drive of the present and the future. That dream built the Canada we cherish. It will help build the Canada we all want in the 21st century.

Consulting With Canadians

Madam Chair, this is my second appearance before this committee as Minister of Finance.

In the four months since I last spoke to you, Canada has continued to post strong economic growth, surprising many analysts with our resilience and leading major economic forecasting agencies to predict that our nation will continue to lead the Group of Seven (G-7) in growth.

But we are also very cognizant of the global risks we face, both now and in the future. Global uncertainties have been rising. Economic growth is turning out to be weaker than expected in a number of industrialized countries. The decline in equity markets, the impacts of corporate scandals in the US, the possibility of armed conflict in Iraq and anxieties over global terrorism – these have all further increased the level of global uncertainty.

Against this backdrop, I am here today to provide an overview of Canada's economic and fiscal forecast for the next five years, which the Government will use for planning purposes and will help frame pre-budget consultations.

Madam Chair, this committee's deliberations have played a key role in establishing the Government's fiscal and economic agenda. Your report, based on consultations held across the country, provides the Government and myself, as Finance Minister, with a clear sense of the fiscal and economic issues that Canadians find important and which we, as parliamentarians, must address.

Over the coming weeks you and I will hear from a wide range of individuals and organizations, all with their own specific ideas about what the upcoming budget should contain.

We know that Canadians are not shy in bringing their views to their elected officials, particularly when it comes to their economic well-being.

Canadians told us to eliminate the deficit and get the nation's finances in order. This government listened. We balanced the budget in 1997-98 for the first time in 28 years and we have kept the books balanced ever since.

Canadians told us to pay down the national debt. Over the past five years we have reduced the debt by $46.7 billion.

Canadians told us they wanted governments to work together to improve health care. In the September 2000 health accord the federal government provided an additional $23.4 billion to the provinces for health care and early childhood development.

Canadians told us to reduce their tax burden. In October 2000 we delivered a five-year, $100-billion tax cut package for both personal and corporate taxes.

Canadians have made it clear that they want a policy of balanced books and a balanced approach to our nation's finances. We agree, because we know – and Canadians know – that sound fiscal management and a prudent approach to spending are the surest path to a better standard of living for our citizens and a higher quality of life for every Canadian. It is how we ensure that Canada is a society of prosperity and opportunity for all. It is how we realize our potential as a "Northern Tiger."

Sound Fiscal Management

Madam Chair, when I met with the Finance Committee in June, I stated that Canada would not deviate from the fiscal and economic policies that have created the most rapidly growing economy in the G-7.

We will stay on course and on target. We will manage the hard-earned tax dollars of Canadians with care and caution. Our approach must be no different from that of Canadian families balancing their household budgets. We must spend wisely and live within our means.

The reasons are convincing and compelling. Sound fiscal management has allowed Canada to record five consecutive budget surpluses and pay down $46.7 billion of our national debt. In simple dollar terms, our debt reduction efforts mean we are now paying almost $3 billion less annually in interest payments, money that is now being used to address the priorities of Canadians. Our debt-to-GDP (gross domestic product) ratio has now fallen from its peak of 71 per cent in 1995-96 to its current level of 49 per cent, the largest decline recorded by any G-7 country in the same period.

This remarkable progress has been recognized by two leading international credit rating agencies. Earlier this year Moody's Investors Service and Standard & Poor's restored Canada's credit rating to Triple-A, the highest rating these agencies give to a country.

Our clear commitment to fiscal responsibility, through economic ups and downs, is paying dividends. It protected the historic October 2000 personal and corporate income tax cuts as well as the new funding under the September 2000 health accord. Coupled with Canada's excellent track record on inflation, it allowed the Bank of Canada to sharply reduce interest rates last year. And our prudent approach kept the Government's finances in surplus during the recent economic downturn.

Canadians' accomplishments in the area of fiscal responsibility are all the more remarkable when you consider the situation in the United States. Less than two years ago the US government forecast a budget surplus of $231 billion for the fiscal year that ended in September 2002. Now, figures released recently show the final result was a deficit of $159 billion, with no early return to surplus in sight.

But, while we have reason to be pleased with Canada's fiscal performance, I believe there is more for us to do. We must continue to pay down debt. Despite the paydowns of recent years, our national debt still stands at more than $536 billion. In the last fiscal year we paid $37 billion in interest charges on our debt. It is still the largest single expenditure item in our budget, costing us some 22 cents out of every revenue dollar taken in. This is money that I would rather see spent on the needs of Canadians.

Moreover, it also means that Canada is vulnerable to economic shocks outside our borders that drive up interest rates.

But beyond the arguments about the consequences of debt today, we must look to the future. We must not saddle our children and grandchildren with today's high debt burden.

Prudence in an Uncertain World

Prudent planning, coupled with the hard work and commitment to fiscal discipline by Canadians from all walks of life, have been crucial elements in our success.

In the past the Government's approach to budget planning has included setting aside a Contingency Reserve and additional prudence to guard against the risks of unforeseen circumstances.

In the 2001 federal budget the Government used the economic prudence and a portion of the Contingency Reserve to deal with the exceptional fiscal pressures caused by the September 11 terrorist attacks and the global economic downturn. At that time we said that we would restore the full Contingency Reserve as soon as possible.

Therefore, today I am pleased to announce that the Government has restored the $3-billion annual Contingency Reserve, effective this fiscal year. This money will provide a buffer against unforeseen circumstances. As usual, any year-end surplus goes to pay down debt. Further, we will provide an additional degree of economic prudence in our budget planning to help ensure that the Government will not return to deficit.

Managing Tax Dollars Wisely

But sound fiscal management means more than simply avoiding deficits and reducing debt. It also means managing tax dollars well and responsibly, and delivering cost-effective and efficient government services. This is why the Government must assess its programs on an ongoing basis.

This is more than just good management. It is good common sense. Just as Canadians adjust their budgets to stretch their hard-earned dollars, the Government must also reassess its spending to ensure it best meets the needs of Canadians.

So, what does this mean in practice?

It means that in preparing the next budget, we will find opportunities to realign existing spending and improve efficiency.

It means that, where appropriate, the Government will reallocate money to programs that meet the immediate needs of Canadians from those that have already served their purpose. Such reallocation will not be used for debt reduction; instead, monies freed up will be used to help address new, pressing needs.

I believe this approach is based on a straightforward premise: that governments at all levels must constantly reinvent themselves. This means we must always strive to find new ways to meet the needs of Canadians in a cost-effective and efficient manner, while supporting the programs and services that make us a caring and compassionate society.

Sound Economic Performance

Madam Chair, when I appeared before this committee in June, I stated that Canadians had good reason to be optimistic about their economic future and that of the country as a whole.

Despite global weakness and uncertainties, Canada has not only emerged from the slowdown of 2001, it now finds itself in the midst of a much better than expected recovery. Consider the facts:

- In the first half of this year the Canadian economy grew at an annualized rate of more than 5 per cent, strongest in the G-7.
- In the nine-month period from January through September the Canadian economy created 427,000 new jobs. The majority of these were full-time, with gains in every region of the country and across all age groups. In fact, 77,000 young Canadians found new jobs during this period.
- Not only are more Canadians working, but they are also seeing an improvement in their personal financial situation. Real personal disposable income per person has increased 2.9 per cent over the last 12 months. That means an average of $600 for each Canadian.

- Canada's net foreign debt as a share of GDP is now at its lowest level in 50 years, and is below that in the US for the first time in our history.
- Growth in business investment in machinery and equipment in Canada, a key element for sustained economic growth, has rebounded in 2002 and is outpacing the US.

To further illustrate our solid economic performance this year, let's compare how the Canadian and US economies have responded during previous economic slowdowns.

In the past, slowdowns tended to be more severe in Canada than in the US, and our recoveries weaker. Indeed, in the 1980s and 1990s Canada had longer and deeper recessions than the US.

But times have changed. For the first time in more than 20 years, the Canadian economy outperformed the US economy during a downturn. The US economy had three consecutive quarters of negative growth last year while Canada avoided recession.

Equally important, we are outpacing the US in the current recovery period. The growth in our economy was almost twice that of the US in the first half of this year. And our record of creating over 400,000 jobs so far this year compares with a loss of almost 40,000 jobs in the US.

Thus, while our economic performance remains closely dependent upon the health of the global economy, particularly the US, the progress we have made has improved the resilience and flexibility of our economy and given us considerable economic momentum.

Canadians should be proud of this accomplishment – namely because it is their own. The people of Canada made clear nine years ago that they wanted a change in how national finances were run. They have worked hard and sacrificed, and accepted difficult choices – making it possible for us to be in this position today. The credit belongs to them.

Economic Outlook

Madam Chair, let me now turn to the economic and fiscal outlook.

First, I would like to explain how we arrived at these figures.

To gauge Canada's growth prospects, the Department of Finance follows a rigorous and transparent process. It has surveyed a group of 20 private sector economists and used their average forecast of economic growth as the basis for our fiscal planning. Three macroeconomic modelling firms then use this economic forecast to generate fiscal projections over the next five years.

I have also met with a group of key private sector economists to seek their views on the projections, as well as the risks and uncertainties to the outlook. These private sector forecasters expect growth to average 3.4 per cent in 2002. This is more than double the 1.5-per-cent growth rate recorded in 2001. For 2003 private sector forecasters now expect economic growth of 3.5 per cent.

Both the International Monetary Fund and Organisation for Economic Co-operation and Development are in broad agreement with the views of the forecasts. They project that Canada will outperform all of its G-7 counterparts in economic growth, both this year and next.

Private sector forecasters expect solid job creation going forward, thanks to ongoing strength in business investment and consumer spending. Over the medium term they project that economic growth will average roughly 3 per cent.

But Madam Chair, they also stressed that, despite the positive Canadian outlook, there are clouds on the horizon. We face a period of global uncertainty in the months to come.

Outside of North America, European growth is forecast to be lower this year than last. Japan remains mired in a protracted slowdown. The fragile financial situation in emerging markets, especially in parts of Latin America, needs to be monitored closely. And most importantly for Canada, the US recovery has been very uneven. Corporate scandals, notably those involving Enron and WorldCom, have damaged investor confidence, not only in the US but globally, and contributed to large equity market declines. Finally, the continuing threat of terrorism and the growing possibility of conflict in Iraq add to global uncertainty. Taken together, these underscore the importance of remaining prudent in our budget planning.

Fiscal Situation and Outlook

Madam Chair, I would like to turn now to our fiscal situation and outlook.

As announced earlier this month in our Annual Financial Report, we have closed the books on fiscal year 2001-02. We realized a surplus of $8.9 billion, every single penny of which went to reduce Canada's debt. This is our fifth consecutive budget surplus, the first time this has happened in my lifetime. Moreover, Canada is the only G-7 country expected to achieve a surplus this year.

Looking ahead, the average private sector projections of the fiscal surplus for planning purposes are as follows:

2002-03: $1.0 billion

2003-04: $3.1 billion

2004-05: $3.5 billion

2005-06: $6.8 billion

2006-07: $10.5 billion

2007-08: $14.6 billion

These planning surpluses take into account the $3-billion annual Contingency Reserve and an additional degree of economic prudence.

These private sector fiscal-planning projections indicate relatively small surpluses in the near term. This is due to two main factors: first, the ongoing impact of last year's economic slowdown upon tax revenues; and second, the effect of previously announced policy initiatives, particularly the $100-billion Five-Year Tax Reduction Plan and the $23.4-billion health accord, both of which are still coming on stream.

Madam Chair, I should note that these figures were calculated using the Government's current modified accrual method of accounting. As indicated in the 2001 budget, and supported by the Auditor General of Canada, the Government will switch to the full accrual accounting system. We are planning that this will take place with the upcoming budget, provided we are able to verify the accrual accounting amounts with sufficient assurance.

Meeting Future Challenges

Canadians know that maintaining balanced budgets and reducing our debt burden are crucial to our long-term economic health, and thus to our broad, national aspirations. But they are not ends unto themselves. They are a very necessary means to achieve our fundamental goal: improving the standard of living and quality of life of Canadians. These efforts are important to all of us as Canadians, not only because improving our standard of living puts more money into our pockets, but also because it provides more people with greater choices and opportunities.

Our efforts in this area are yielding results. Since we eliminated the deficit we have made significant strides in boosting the growth in our standard of living. Over the past five years both employment and productivity growth have been important contributors to the improvement in our standard of living. From 1997 to 2001 Canada recorded the fastest rate of growth in GDP per capita – which represents the best measure of living standards – among the world's leading industrialized countries, including the US.

While we have made good progress, the message is clear: if we want the kind of long-term, durable economic growth that will continue to boost our standard of living and our quality of life, we must improve our productivity growth as a nation.

We have been talking about productivity for some time now. Some people might see it as an abstract economic term which has nothing to do with real people and their day-to-day lives.

I disagree. Improving productivity is about attaining that higher standard of living that we all want, and that our country deserves. It is not about people working harder and for less pay. That would defeat the purpose. Rather, it means working more effectively through improved skills, equipment and education.

Improved productivity does more than boost a company's bottom line. It means more income and better jobs for employees. It means that more and more Canadians, wherever they live, will have the chance to learn and have more opportunities for personal growth and development.

Recognizing this, the Speech from the Throne outlined initiatives that the Government will undertake to ensure that Canada's productivity growth continues to rise, and with it, the Canadian standard of living.

A key element in raising productivity growth will be to make Canada a magnet for talent and investment – a critical part of how we position ourselves as a Northern Tiger.

To encourage investment and entrepreneurship, we will review existing policies to ensure that our regulatory environment is as efficient, transparent and cost-effective as possible.

To protect the integrity and efficiency of our capital markets, we will work with all stakeholders and the provinces to implement new standards of corporate governance and to reform our current system of securities regulation.

But Canadians understand that investment in people is the intersection between our economic and social policies. And nowhere is this integration of economic and social policy more important than health care. This is why we will work with all stakeholders to ensure Canada's health care system can continue meeting the needs of Canadians in the 21st century, and provide Canadians with a distinct advantage in the world.

Last week Senator Michael Kirby and his colleagues released a wide-ranging report on options for health care in Canada. In the coming weeks the Commission on the Future of Health Care in Canada, led by former Saskatchewan Premier Roy Romanow, will table its report. Both reports will help governments in their future deliberations to develop a national approach to addressing Canada's health care needs.

Our government will do its part. The Prime Minister has indicated that we will work with the provinces and territories to agree on a long-term plan to modernize medicare, with a First Ministers Meeting early in the new year. We will provide resources to support implementation of that plan in the upcoming budget.

Madam Chair, our future depends on providing the best possible opportunities for our children. As a society, we must strive to ensure that every Canadian child, no matter where they live, has the best possible start in life and the chance to achieve their full potential.

This is why we have committed to further increase the National Child Benefit for low-income families, building on our reinvestments in recent years. Our challenge is nothing less than to equip our children with what they need to succeed in a rapidly changing world. Nowhere is this need more urgent than with Canada's Aboriginal children.

Our challenge is also to invest in our nation's infrastructure, building, for ourselves and our children, competitive cities and healthy, safe communities.

But that is not all.

Madam Chair, in the interest of future generations, it falls to this generation of Canadians to confront the issue of improving our environment. Canadians want clean air and clean water and they are concerned about the impact of climate change. On this, our government is working with the provinces and industry to ensure that Canada lives up to its international responsibilities on climate change, as embodied in the Kyoto accord.

These are important steps in what must be a continuous effort to shape our economy to meet the needs of both today's citizens and future generations.

Conclusion

Statistics and percentages can shed a lot of light on where we stand as an economy, but we must never allow them to obscure what we stand for as a government and as members of Parliament. And that is to make the lives of individual Canadians and their families better and more secure than ever.

Madam Chair, there is a whole new generation of Canadians ready to take on the challenge of building an even stronger, more prosperous and more generous Canada. Their view is global and their dedication to this country and the values it stands for is inspiring.

People like Carla MacQuarrie of West Chezzetcook, Nova Scotia, who has combined the sciences of aquaculture and agriculture to create a successful farming operation that produces high-quality hydroponic vegetables and herbs.

Carla and her husband Peter Lenihan and their other partners, Dave and Joanne Roberts, own and operate Future Aqua Farms Limited. This company has attracted worldwide attention for its unique use of aquaculture technology, and Carla herself was one of 18 young business people between the ages of 19 and 30 who were recently awarded the Business Development Bank of Canada's (BDC's) Young Entrepreneur Award.

This award recognizes outstanding young Canadian entrepreneurs in every province and territory who, through hard work and determination, have overcome the odds to develop successful and innovative new businesses.

Carla and the other BDC award winners are just some of the young leaders who are helping to shape Canada's future. These young Canadians – confident, well-educated, globally sensitive and technologically savvy – are our best hope for making Canada represent not only what is good, but what is best in the world.

Madam Chair, Canadians will be asked by this committee to offer their views on the priorities the Government should focus on in its next budget. Over the coming weeks you will hear from groups and individuals across Canada who will have a wide range of opinions. Like you, I will be travelling across the country in the days ahead to hear the views of Canadians. Undoubtedly, you and I will hear many good ideas.

But you know, just as I know, that the business of government is about making choices. If all of the ideas that we will hear over the coming weeks were to be implemented, our small surpluses would rapidly become large deficits once again. We cannot allow this to happen. And so, choices will have to be made.

With this in mind, I would ask the committee to provide input to the Government on the following questions:

- In June I asked for the committee's views on how the Government can best control expenditures and focus priorities. Further to this issue, I would seek the committee's input on how the Government can best realign its spending to meet the highest priorities of Canadians.

– As I mentioned earlier, the Government has restored the $3-billion annual Contingency Reserve. To further guard against going back into deficit, what additional amount of economic prudence should be included in the upcoming budget?

– The idea of making Canada a Northern Tiger has captured the imagination of citizens across the country. What policies do Canadians think we need to make our country a magnet for investment, for skilled knowledge workers, and for cutting-edge research and innovation?

Madam Chair, the consultations this committee is pursuing with Canadians are not just about what should be contained in the next budget – they are also about the kind of Canada we want.

I believe the Canada we want is fiscally healthy, so that we are free to choose our own path and to shape our own destiny.

It is a Canada where economic and social policies work hand in hand.

It is a Canada that is more productive, more innovative and more competitive than ever, so we can generate the resources needed to invest in our future priorities – health care, the environment and our children.

It is a Canada that embraces a fair and competitive tax system.

It is a Canada that plays an important role on the world stage, helping to build a more stable and more just global community.

It is a Canada that is a magnet for talent and investment, a Northern Tiger, confident it can take on the world and win.

In short, it is a Canada that strives to give its citizens not only a better standard of living, but the best standard of living in the world.

Not only a better quality of life, but the best quality of life in the world.

A Canada that continues to earn its reputation as one of the most compassionate, inclusive and progressive nations on earth.

Madam Chair, I began my remarks today by referring to the debt that the present generation of Canadians owes to those who passed through this building on their way to a new life in a new land.

Just like the hundreds of thousands of Canadians who came through Pier 21 believing that tomorrow can be better than today, I, too, believe in the great potential of this great place called Canada.

Annexes

Annex 1

Canada's Recent Economic Developments and Outlook[1]

[1] Incorporates data available up to October 21, 2002.

Highlights

- *The Canadian economy has emerged from the slowdown of 2001 into a solid recovery, outpacing the United States and other Group of Seven (G-7) countries in both gross domestic product (GDP) and employment growth.*

- *Canada's resilient economic performance during the global slowdown reflected the turnaround in the fiscal situation and the achievement of sustained low inflation, which enabled the Government and the Bank of Canada to provide timely support to the economy through lower taxes and interest rates.*

- *Strong fundamentals have led to robust employment gains of 427,000 over the first nine months of this year, which have been distributed across all regions and reflected in the continued growth of real disposable income of Canadians.*

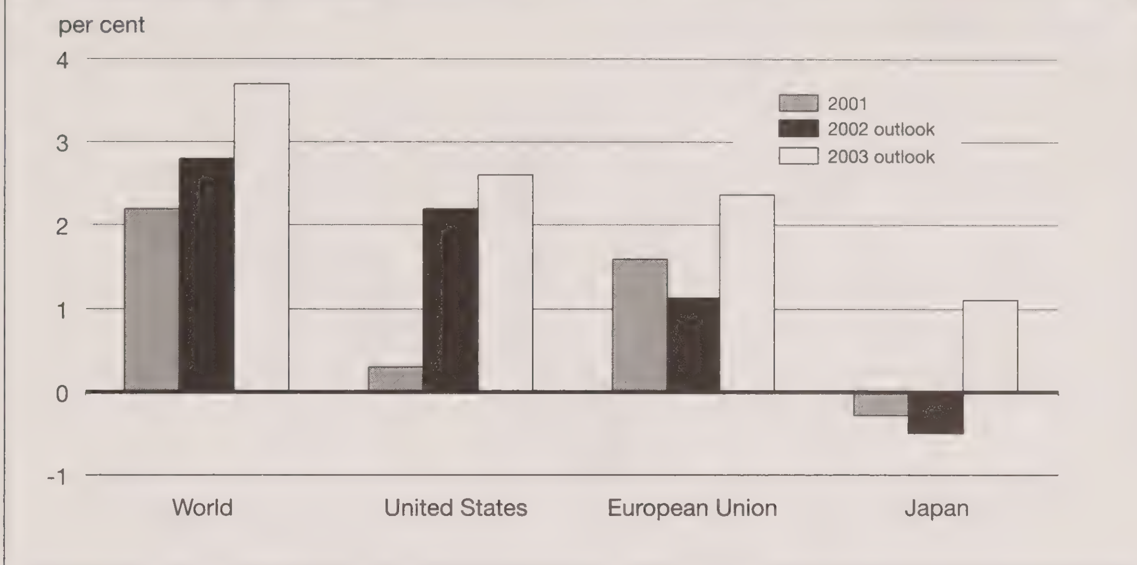
- *Private sector forecasters expect continued solid growth in the Canadian economy. The Department of Finance survey of private sector economists in September shows a moderation in growth in the second half of this year from the strong pace exhibited in the first half, leading to forecast growth of 3.4 per cent for 2002 as a whole. For 2003 they expect growth to average 3.5 per cent.*

- *While the economic outlook has improved substantially since the December 2001 budget, there are significant risks to the outlook, stemming mainly from uncertainty about the near-term momentum of the US recovery. US growth has been uneven so far this year, and forecasters expect only a modest pickup in growth in the second half of the year.*

- *Accounting and corporate scandals and the decline in equity markets, combined with the threat of war in Iraq, pose significant risks to the US economic outlook.*

A global economic recovery has been underway since late 2001

World Real GDP Growth

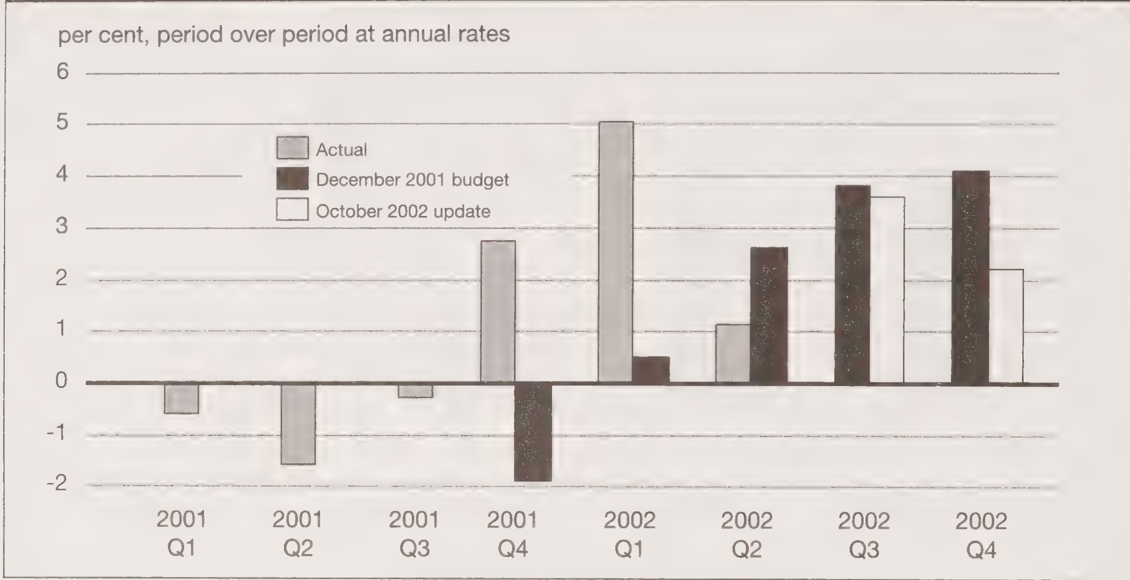


Source: International Monetary Fund, *World Economic Outlook*, September 2002.

- At the time of the December 2001 budget the International Monetary Fund (IMF) projected global growth of 2.4 per cent in 2002. By September this had been revised up to 2.8 per cent as a result of stronger-than-expected growth in late 2001 and early 2002.
- The IMF expects global growth to improve in 2003, although developments in recent months have led to some downward revisions to growth prospects for next year, largely in the US.
- Going forward, risks to the global outlook have increased, particularly stemming from uncertainty about the pace of the US recovery.
- While US growth at the beginning of this year was greater than expected, concerns about the pace and sustainability of the recovery have risen. Indeed, recent indicators suggest that the recovery is weakening in the US. Moreover, European growth is expected to be weaker in 2002 than in 2001, and Japan remains in recession. A sharp spike in oil prices resulting from a possible war in Iraq and continued equity market weakness could slow global growth. Also, financing conditions in emerging markets remain fragile, particularly in South America.
- Nonetheless, the IMF expects all three major economic blocs to experience positive growth next year.

Growth in the US in late 2001 and early 2002 was stronger than anticipated, but has been uneven more recently

US Real GDP Growth

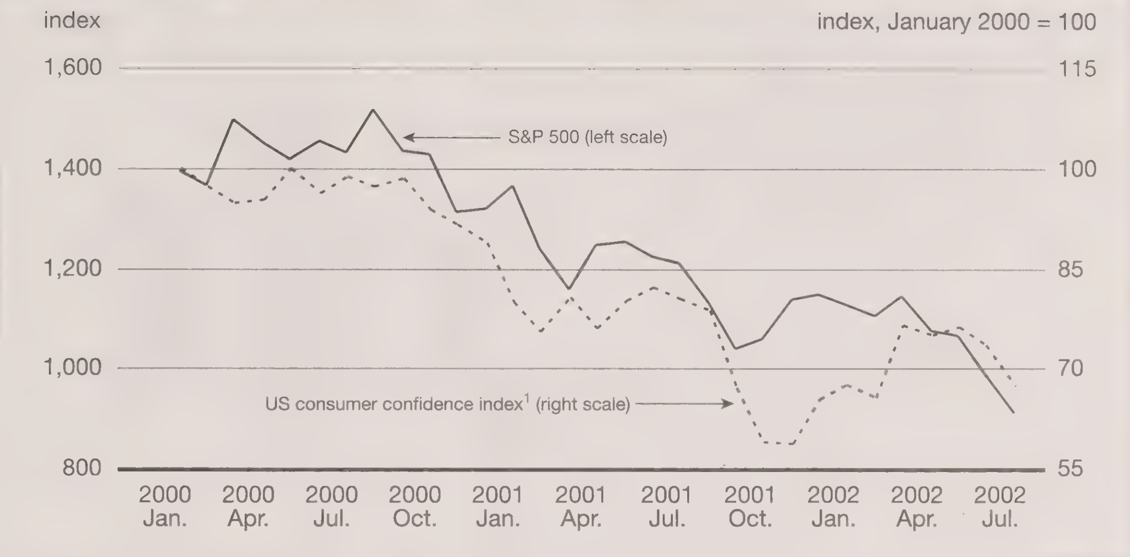


Souces: *Blue Chip Economic Indicators*, November 2001 and October 2002.

- Following strong growth in the late 1990s and 2000, the US economy experienced a recession in 2001, with three consecutive quarters of negative real GDP growth.
- This downturn was largely the result of a sharp correction in US business investment in information and communications technology goods (accompanied by a steep decline in equity prices), which was exacerbated by a weakening in global demand conditions.
- US growth in the last quarter of 2001 and first quarter of 2002 was much stronger than expected at the time of the December 2001 budget due to fiscal measures and the impact of low interest rates on household demand. Also, special factors such as zero-per-cent financing on new automobile purchases and a need by firms to replenish depleted inventories tended to bring forward future expenditures.
- As the impact of these special factors faded, US growth slowed to just above 1 per cent in the second quarter of 2002.
- Although forecasters expect growth to rebound in the third quarter, uncertainty about the pace of the recovery has risen.

There are significant risks to the US outlook

S&P 500 Index and Consumer Confidence



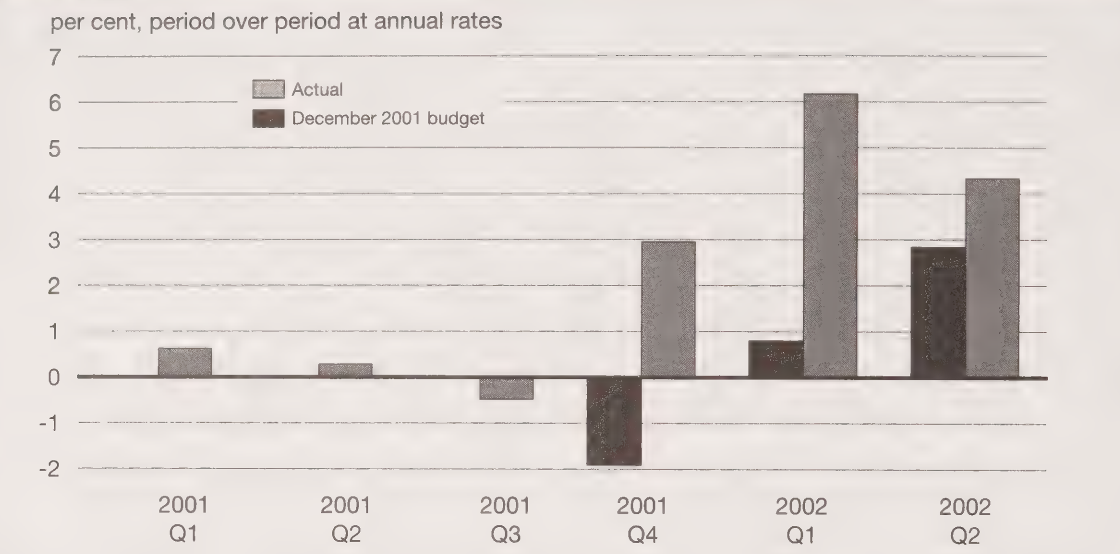
[1] The Conference Board's Consumer Confidence Index.

- Since March of this year US equity markets have declined sharply, exacerbated by accounting and corporate scandals. This continues a trend decline in US stock markets since mid 2000, which has been reflected in similar drops in consumer confidence. If stock price weakness persists, it could further erode consumer and business confidence and slow the US economy.

- Continued uncertainty regarding developments in the Middle East, particularly with regard to Iraq, and the impact such developments could have on world oil prices and consumer and business confidence, present additional downside risks to the US outlook.

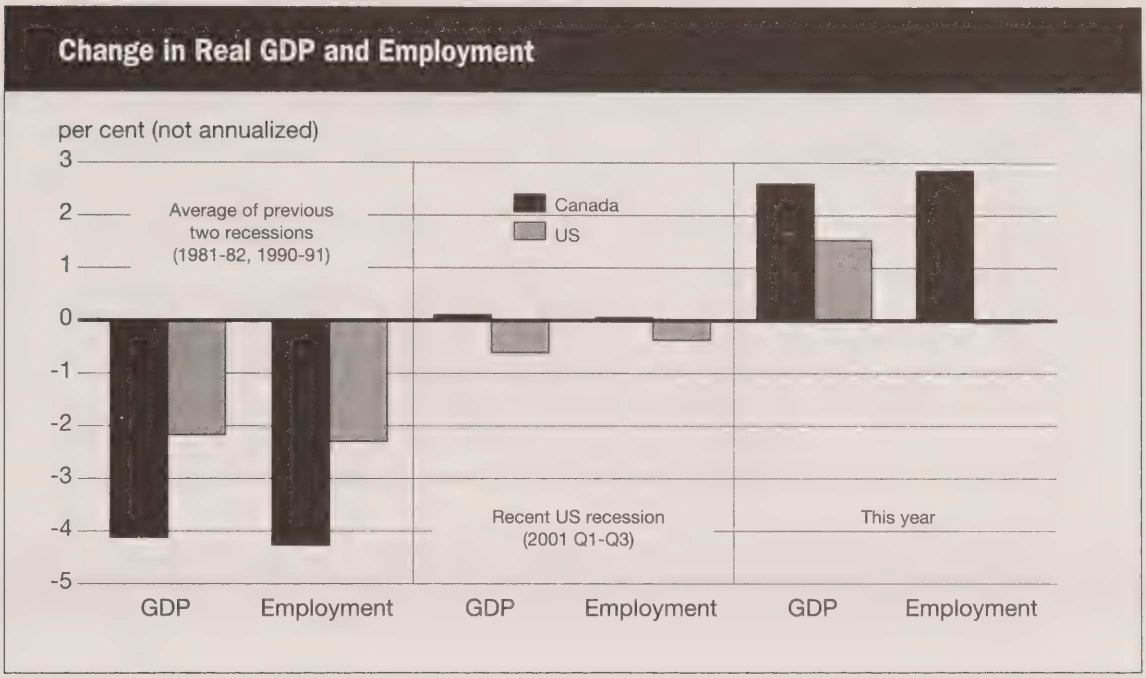
Canada's economy has emerged from the slowdown of 2001 into a robust recovery

Canadian Real GDP Growth



- While Canada did experience one negative quarter of growth in 2001, it avoided the recession that hit the US.
- The Canadian economy has rebounded earlier and more strongly than expected at the time of the December 2001 budget. During the first half of this year the economy grew over 5 per cent at an annual rate.
- Growth has been solid in the broad categories of domestic demand: consumer spending, housing construction and, more recently, business investment.
- The Canadian economy outperformed the US economy during the downturn, and so far this year in both output growth and job creation. The elimination of the deficit and the restoration of fiscal and monetary policy credibility in Canada have underpinned that solid economic performance.

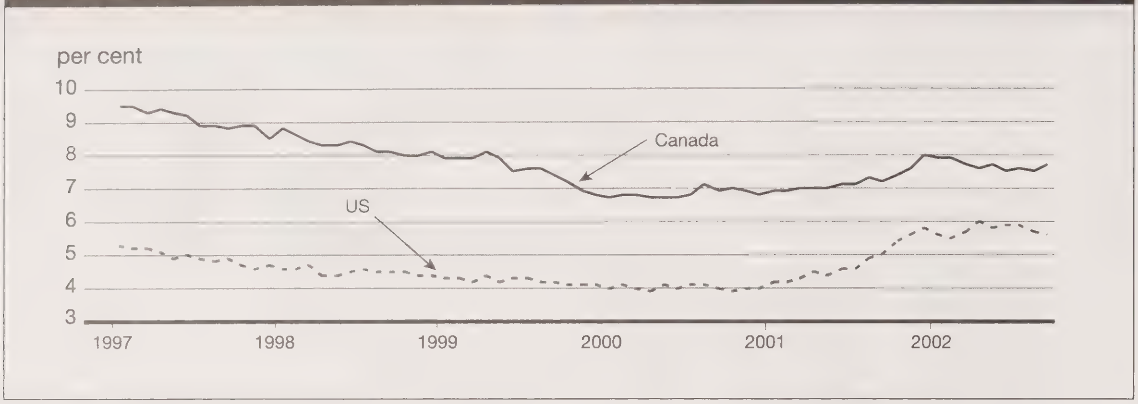
The Canadian economy outperformed the US economy during the 2001 global downturn and again so far this year



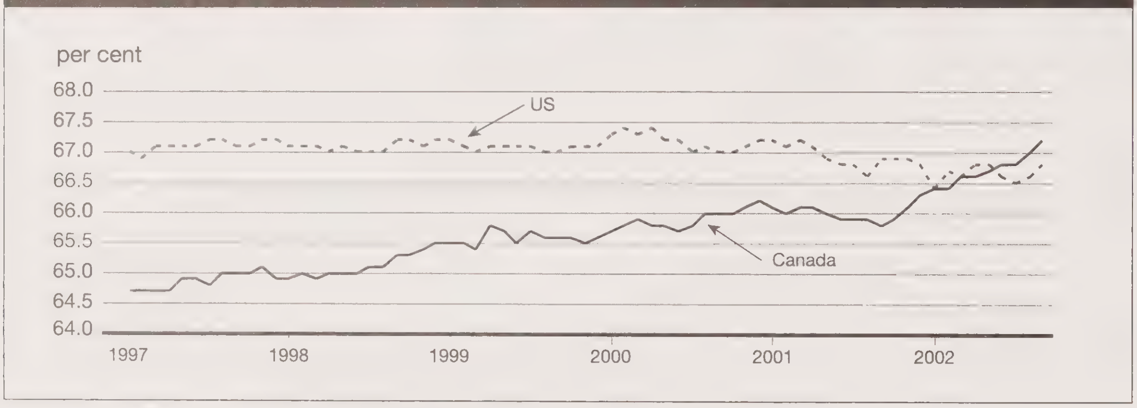
- Canada performed better than the US during the 2001 US recession. This stands in sharp contrast to our poorer performance in the recessions of the early 1980s and early 1990s.
- During these two recessions real GDP and employment in Canada declined more than in the US. In contrast, during the 2001 US recession real GDP and employment actually rose in Canada, while they declined in the US.
- The Canadian economy has continued to outperform the US economy during the recovery. In the first two quarters of 2002 Canadian real GDP growth averaged more than 5 per cent (annualized), compared to 3 per cent in the US. And over the first nine months of this year 427,000 jobs were created in Canada, compared with an employment decline of 36,000 in the US.

Canada's unemployment rate gap with the US has narrowed significantly

Unemployment Rate



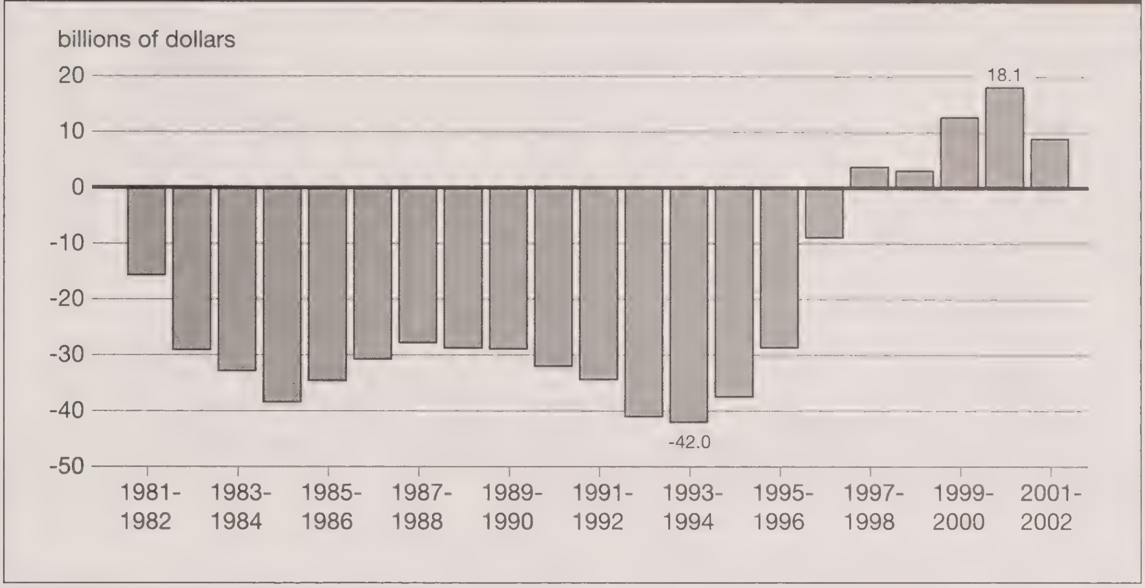
Participation Rate



- The Canadian unemployment rate has dropped from 8.0 per cent at the end of last year to 7.7 per cent in September.
- Canada has narrowed its unemployment rate gap with the US from almost 5 percentage points in late 1996 to about 2 percentage points in September. If the Canadian unemployment rate were to be measured according to the US definition, the gap would be only 1.5 percentage points.
- The fall in Canada's unemployment rate comes despite a sharp increase in the participation rate (the share of the working-age population that is working or actively looking for work) to its highest level in 12 years – reflecting rising confidence in job market prospects. In contrast, the US participation rate has recently trended downward and is now below the Canadian rate for the first time since 1991.

Canada's solid economic performance reflects the substantial improvement in our fiscal position

Federal Budget Balance

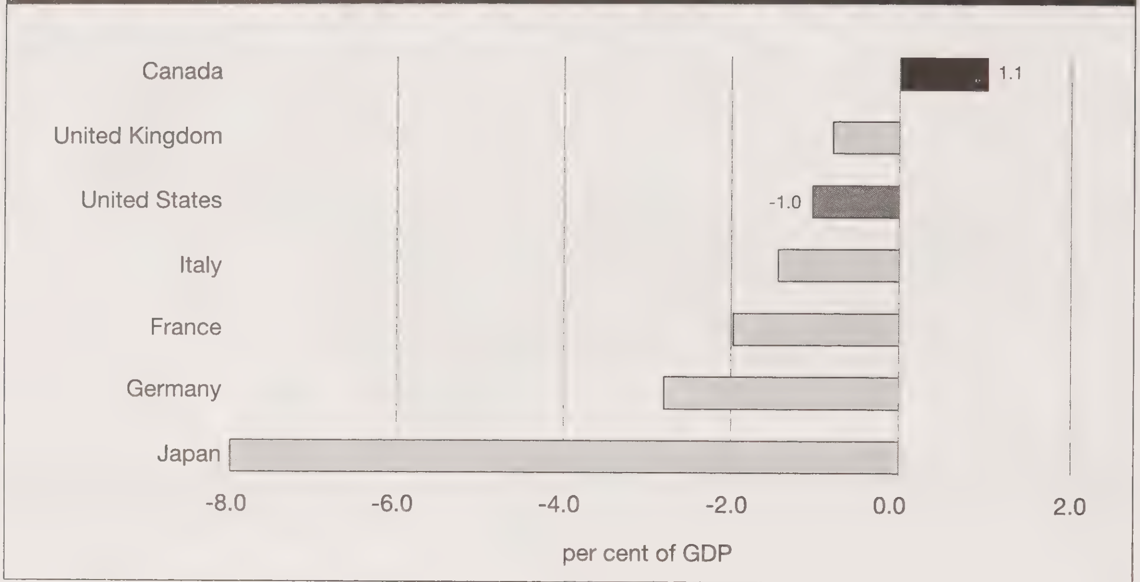


Sources: *Public Accounts of Canada* and Statistics Canada.

- Canada's impressive economic performance during the global slowdown was underpinned by the turnaround in the fiscal situation and the achievement of sustained low inflation. This enabled fiscal and monetary policy to provide timely support to the Canadian economy through lower taxes and interest rates.
- Over the last few years the fiscal position of the federal government has improved significantly – moving from large chronic deficits to consistent budgetary surpluses.
- In fact, fiscal year 2001-02 marks the fifth consecutive year of budget surpluses for the federal government. Over this five-year period the federal government has paid down $46.7 billion in debt.
- This is the result of a systematic fiscal strategy, which the Government has followed for several years. It includes a prudent approach to budget planning, controlling overall spending growth, reallocating spending to priority areas and paying down debt.
- This strategy enabled the federal government to stay in surplus during the global economic downturn last year while fully implementing the $100-billion tax cut plan and taking new measures in the December 2001 budget to enhance security for Canadians.
- This is in stark contrast to the last two recessions in Canada, during which the Government did not have fiscal flexibility.

Canada's fiscal position is projected to be the best among G-7 countries in 2002

Total Government Budget Balances in G-7 Countries, 2002 Projection[1]



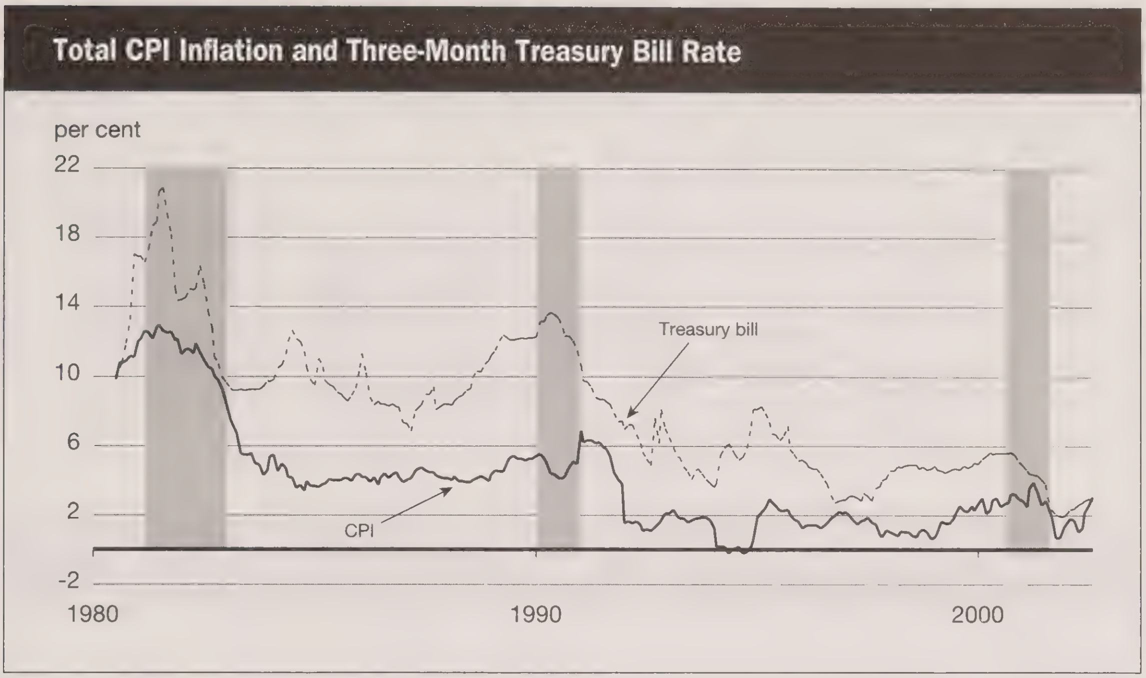
[1] Includes all levels of government.

Source: *OECD Economic Outlook No. 71* (June 2002).

- According to the Organisation for Economic Co-operation and Development (OECD), Canada will be the only G-7 country to record a financial surplus at the total government sector level in 2002.

- This is a continuation of Canada's strong performance relative to G-7 countries in the 1990s. Indeed, since 1997 Canada has consistently recorded the highest total government sector surplus of all G-7 countries, relative to the size of the economy.

Inflation has remained low and stable



Note: For 1981-82 and 1990-91 recessions, shaded areas denote peak to trough in real GDP. For the 2001 slowdown, shaded area is 2000 Q4 to 2001 Q4.

Source: Statistics Canada.

- Low and stable inflation has established the credibility of Canadian monetary policy. In fact, Canadian inflation averaged 1.6 per cent over the 1992 to 2001 period – the third lowest average inflation rate among G-7 countries and well within the inflation target range of 1 to 3 per cent.

- This monetary policy credibility, reinforced by the turnaround in Canada's fiscal situation, has increased Canada's monetary policy flexibility.

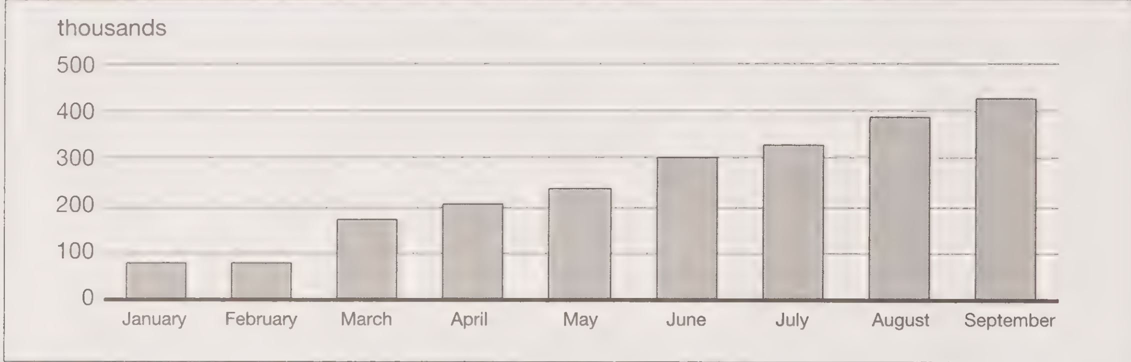
- As a result, the Bank of Canada was able to lower interest rates last year as soon as the economy showed signs of weakness. From January 2001 to January 2002 the Bank lowered its key interest rate by 375 basis points, providing strong support to interest-sensitive sectors such as housing, consumer expenditures and business investment.

- In response to stronger growth, and in order to achieve the 2-per-cent mid-point of the 1 to 3 per cent inflation target range over the medium term, the Bank has raised its key interest rate by 75 basis points this year to remove part of the monetary stimulus in the economy.

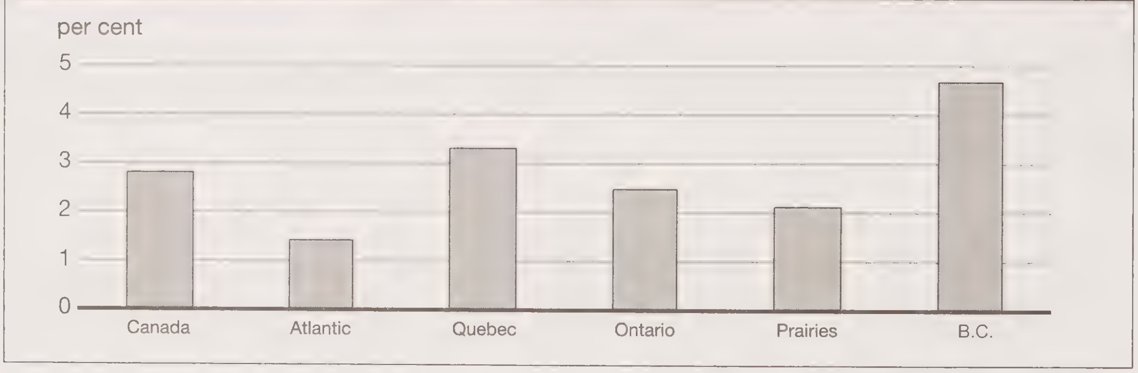
- Nonetheless, short-term interest rates remain at low levels not seen since the early 1960s. These rates will continue to support growth.

Strong fundamentals have set the stage for robust employment gains, which have been distributed across all Canadian regions

Cumulative Employment Growth in Canada
(January to September 2002)

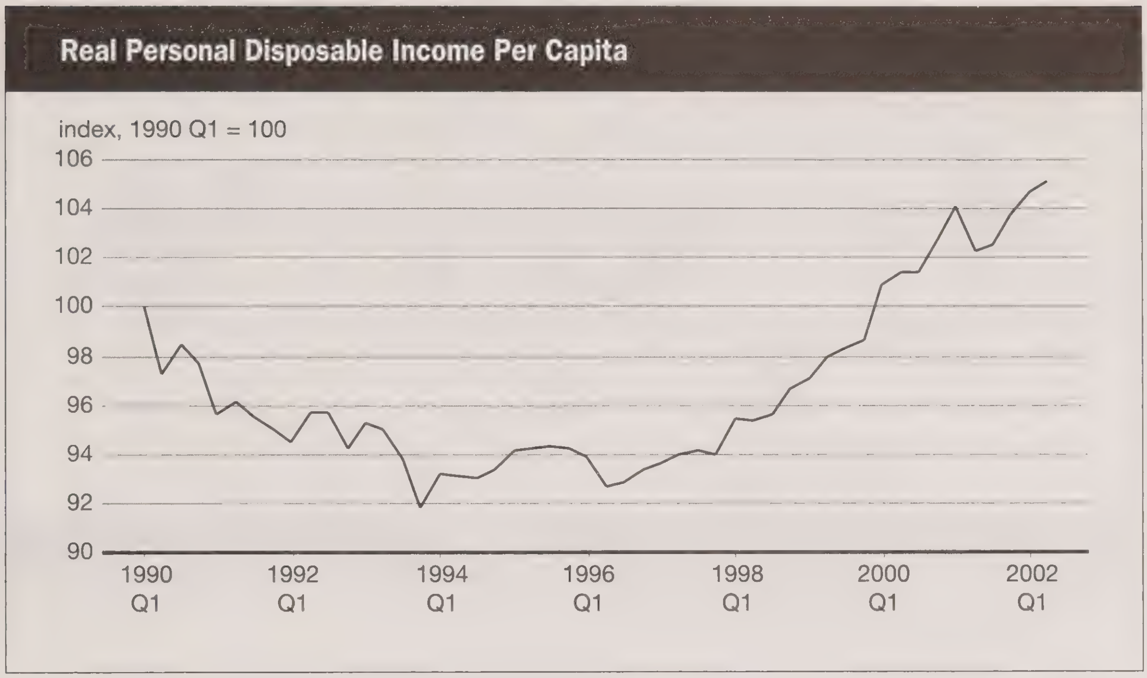


Regional Employment Growth in Canada
(January to September 2002)



- Canada's strong labour market has helped to support domestic demand.
- From January to September 2002 our economy created 427,000 jobs, 60 per cent of which were full-time. This is one of the largest nine-month Canadian employment gains on record.
- Canada's substantial employment gains have been spread across all regions. B.C. and Saskatchewan have led the provinces so far this year, with employment growth of 4.7 and 4.5 per cent respectively. New Brunswick, Quebec and Prince Edward Island have experienced employment growth of over 3 per cent.

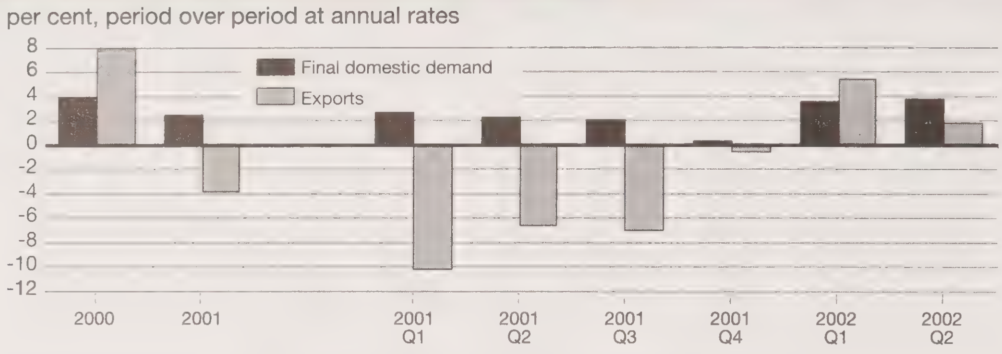
Employment gains are reflected in the continued growth in the real personal disposable income of Canadians



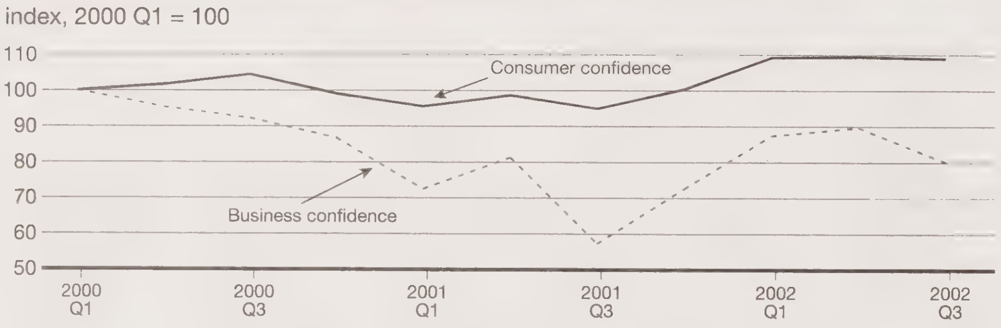
- Real personal disposable income per capita has increased 2.9 per cent over the last 12 months, as solid labour market gains have translated into more disposable income for Canadians.
- This is a continuation of an upward trend since 1997, which is the direct result of a robust labour market, strong productivity growth and substantial tax cuts at both the federal and provincial levels of government.
- This is in a stark contrast to the declining trend in real personal disposable income per capita during the first half of the 1990s.

Strong employment growth and rising incomes have supported domestic demand and consumer and business confidence

Real Final Domestic Demand and Export Growth



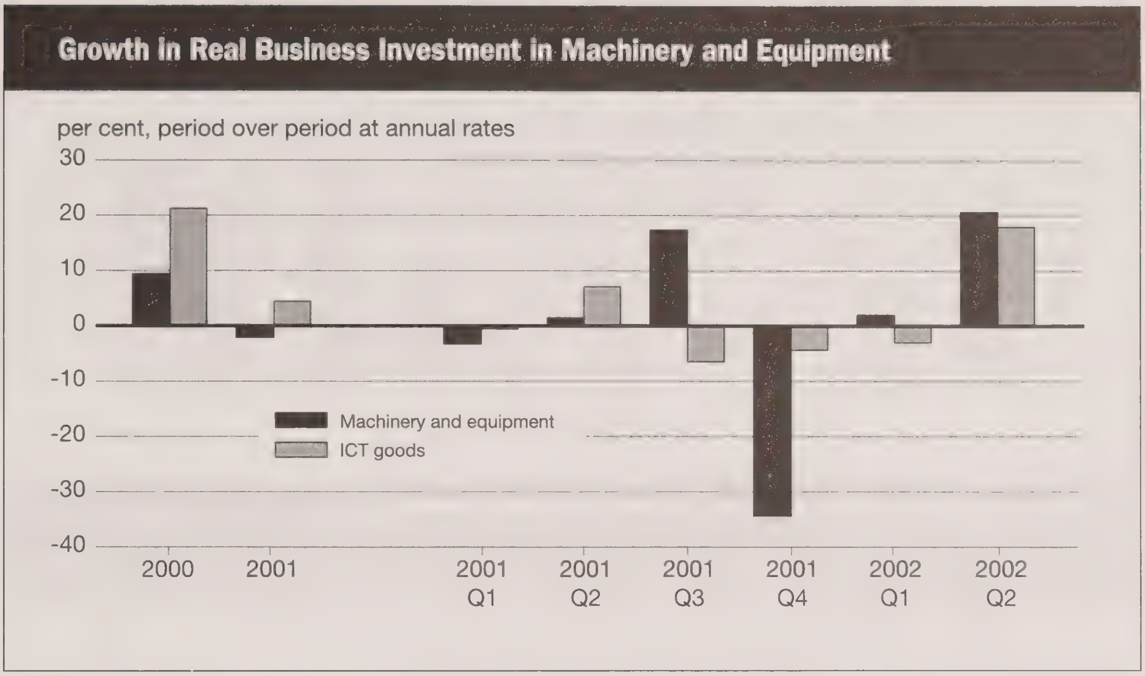
Confidence Indicators



Source: The Conference Board of Canada.

- Healthy growth in Canadian domestic demand provided the support that kept Canada out of recession in 2001, when the slowdown in the US reduced exports.
- Consumer confidence in Canada has remained high. Reflecting this, consumer spending and housing activity have been strong, supported by low interest rates, tax cuts and a robust labour market performance, which have boosted consumers' incomes.
- Business confidence in Canada has recovered following the declines last fall, supported by a 50-per-cent annualized increase in corporate profits in the first half of 2002. At 11 per cent of nominal GDP in the second quarter of 2002, corporate profits in Canada are currently above their historical average.

After declining in 2001, machinery and equipment investment grew in the first half of 2002

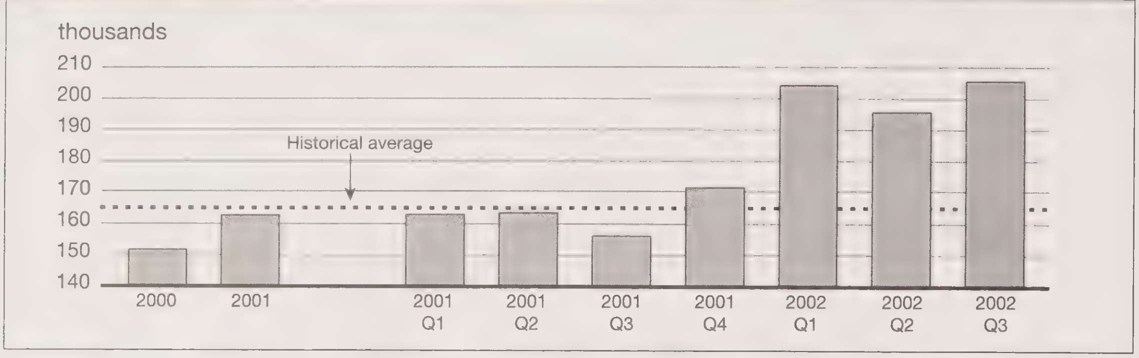


- After declining in 2001, business investment in machinery and equipment (M&E) has recently showed signs of recovery, reflecting improved confidence in economic prospects and the profit recovery. However, even with the rebound in the second quarter of 2002, M&E investment was still below the level recorded a year earlier.

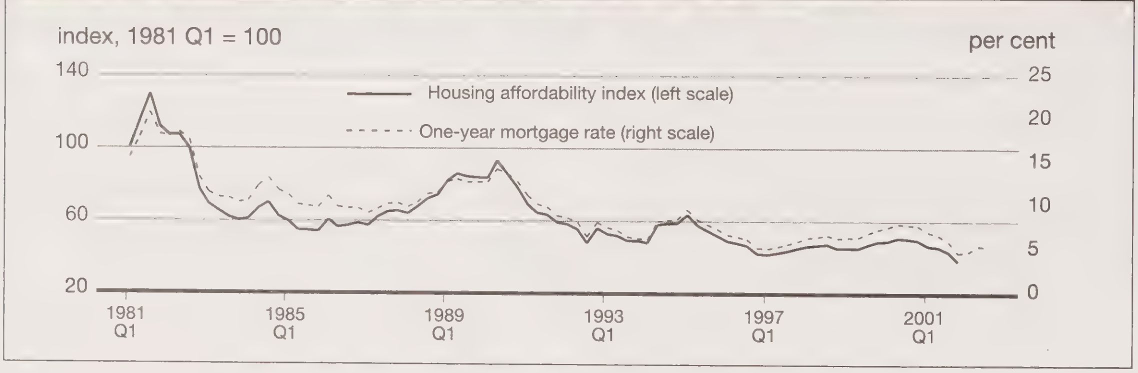
- Higher investment in information and communications technology (ICT) has contributed to the recent growth in M&E investment. The 18-per-cent increase in ICT investment in the second quarter represented the first major increase in almost two years.

The housing sector has been particularly strong

Housing Starts



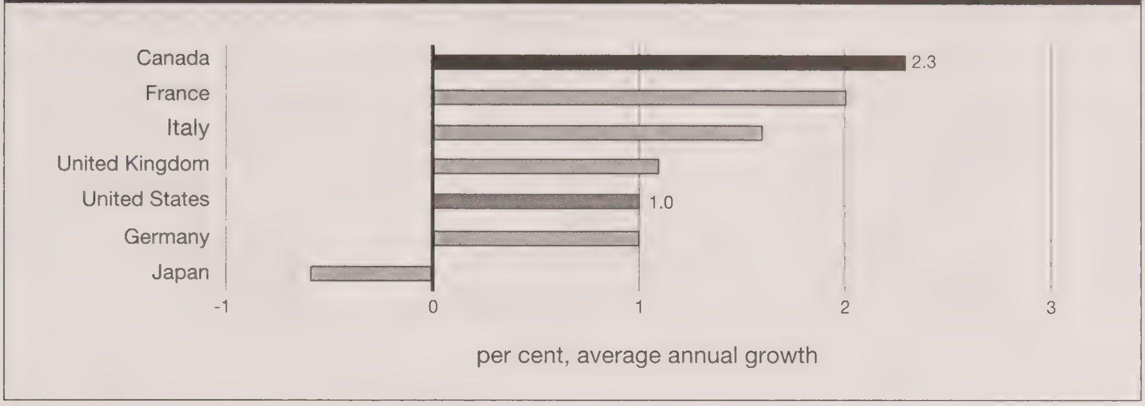
Housing Affordability Index and One-Year Mortgage Rate



- Residential investment is 15 per cent higher than at the beginning of 2001. Both housing starts and renovations have contributed to the strength in residential investment.
- At over 200,000 in the first nine months of 2002, housing starts are at their highest level since 1989 and well above their historical average of 165,000 starts.
- Strong housing demand reflects rising employment and incomes, and low mortgage rates. The housing affordability index, which represents the proportion of average disposable household income needed to make mortgage payments on an average new house, improved throughout 2001 and reached its best level on record.
- Since the beginning of 2001, one- and five-year mortgage rates have declined 240 and 95 basis points respectively, and are currently 5.3 per cent and 7.0 per cent. Households now save close to $1,700 annually on a new or renegotiated one-year mortgage of $100,000 compared to what they would have paid at the beginning of 2001, while they save more than $700 annually on a five-year mortgage.

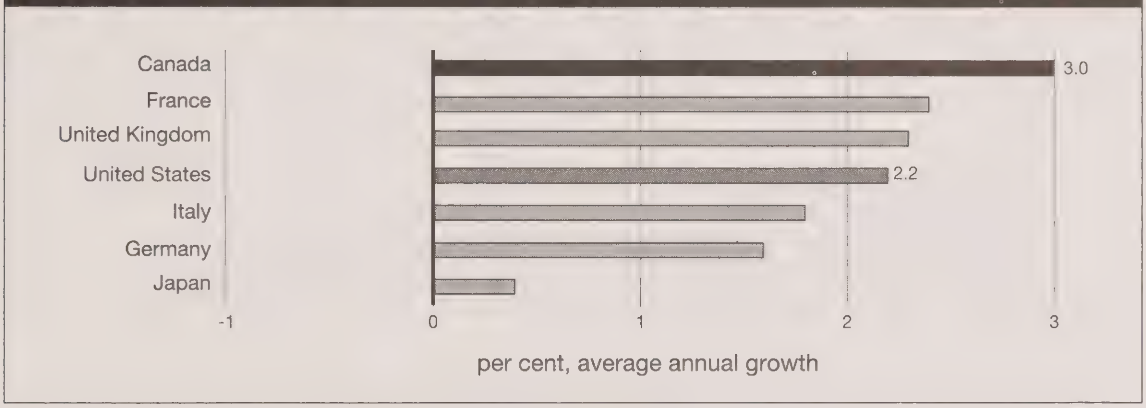
A better labour market performance and improved productivity growth in Canada have resulted in stronger growth in Canada's standard of living

Employment Growth From 1997 to 2001 in G-7 Countries



Sources: Statistics Canada, Bureau of Economic Analysis and *OECD Economic Outlook No. 71* (June 2002).

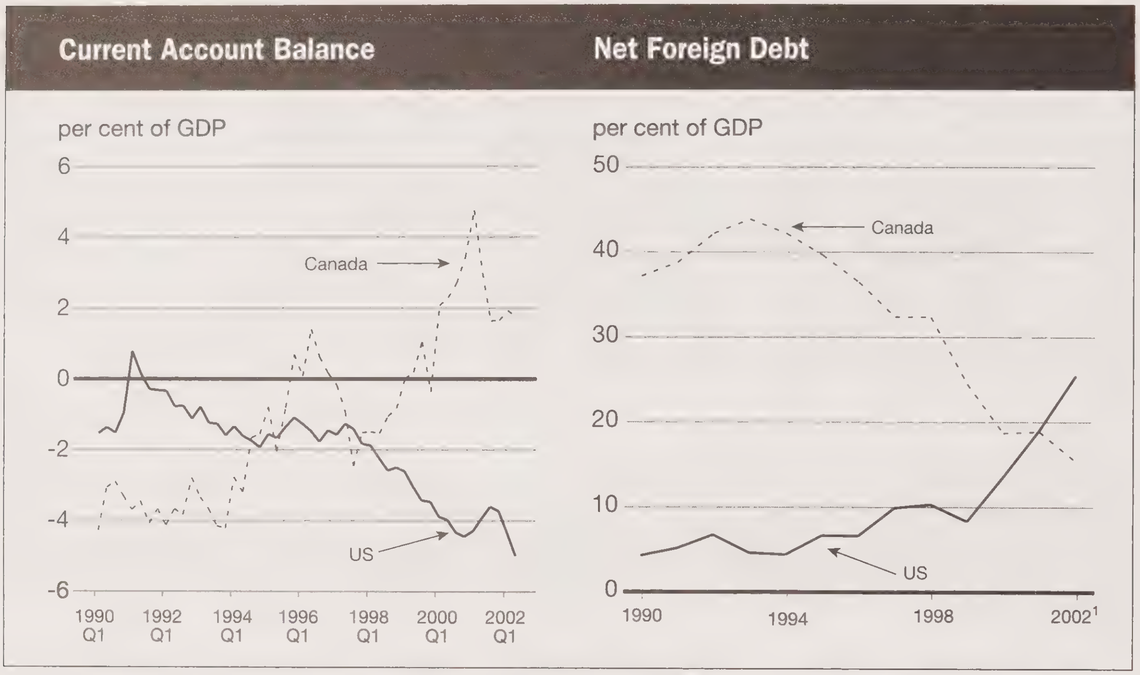
Real GDP Per Capita Growth From 1997 to 2001 in G-7 Countries



Sources: Statistics Canada, Bureau of Economic Analysis and *OECD Economic Outlook No. 71* (June 2002).

- Canada's strong job creation this year is a continuation of the performance of the last five years. In fact, from 1997 to 2001 average Canadian employment growth well exceeded that of the other G-7 economies.
- This solid labour market performance, combined with improved productivity growth, has resulted in a significant improvement in growth in real GDP per capita, which is a widely used measure of improvement in living standards.
- From 1997 to 2001 real GDP per capita growth averaged 3.0 per cent per year in Canada, outperforming all other G-7 countries.
- While the living standards gap with the US has started to narrow in the last five years, it remains sizeable and more progress on a sustained basis will be needed to close the gap.

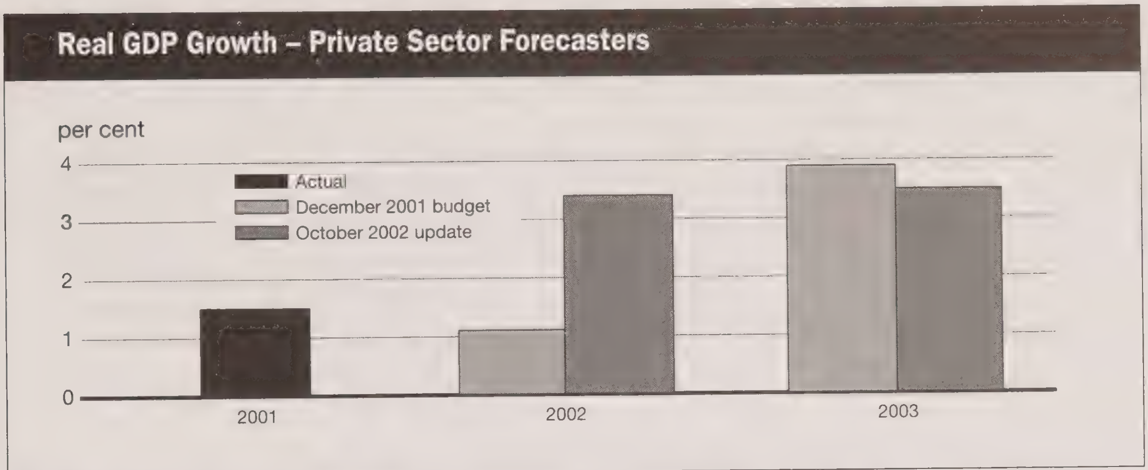
Canada's current account balance and net foreign indebtedness have improved significantly, while US balances have deteriorated



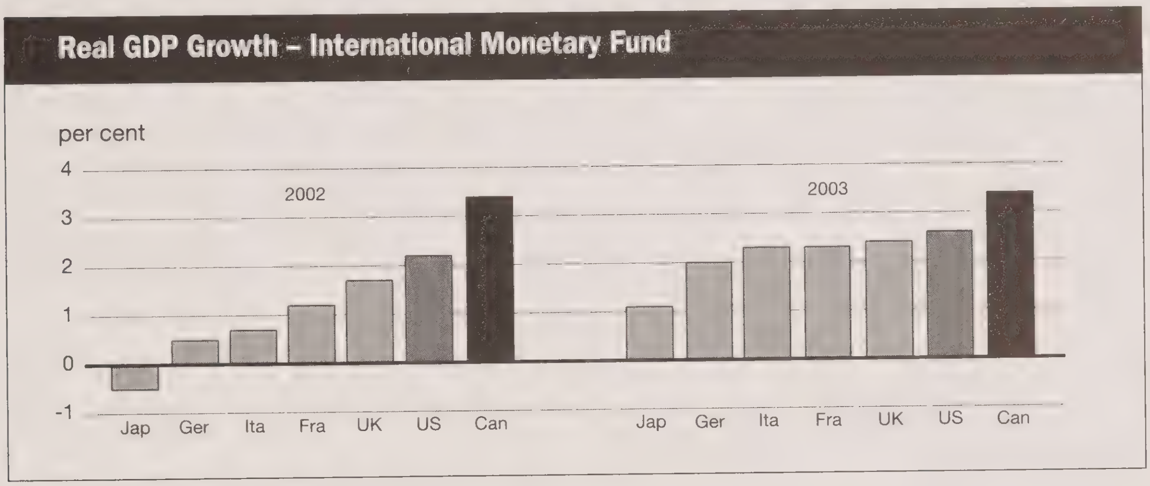
[1] Estimates: Based on current account estimates from the Department of Finance for Canada and DRI-WEFA for the US.

- Canada's stronger economic performance in recent years can also be seen in our current account balance, which has gone from large deficits through the 1980s and most of the 1990s to large surpluses today, despite the US economic slowdown.
- As a result, our net foreign debt as a per cent of GDP fell to below 20 per cent in 2001, less than half the levels of the early 1990s and the lowest level in more than 50 years.
- This means that more of the income that Canadians earn is staying in Canada.
- Canada's net foreign debt as a share of GDP is now lower than that of the US for the first time on record.

Forecasters expect continued growth in the Canadian economy



Sources: December 2001 and September 2002 Department of Finance surveys of private sector forecasters.



Source: IMF.

- The Department of Finance conducted its regular survey of Canadian private sector economists in September, which is the basis for the fiscal projections provided in Annex 3.
- Private sector forecasters expect Canadian economic growth to moderate from the strong pace exhibited in the first half of the year, leading to forecast growth of 3.4 per cent for 2002 as a whole. For 2003 they expect growth to average 3.5 per cent.
- GDP inflation is expected to remain low at 1.1 per cent in 2002, but to increase to 2.3 per cent in 2003. This results in expected nominal GDP growth of 4.6 per cent in 2002 and 5.9 per cent in 2003.

- Private sector forecasters expect short-term interest rates to increase from 2.6 per cent in 2002 to 3.9 per cent in 2003. Current private sector expectations for the 10-year government bond rate is 5.3 per cent in 2002 and 5.5 per cent in 2003.

- The IMF and OECD expect Canadian growth to rank first among G-7 countries in both 2002 and 2003.

- While the economic outlook has improved substantially since the December 2001 budget as a result of the earlier-than-expected economic recoveries in both Canada and the US, there are significant risks to the outlook. The primary risk to the Canadian outlook is continued uncertainty about the near-term momentum of the US recovery. In particular, continued equity market weakness could slow the US recovery in business investment and depress US household spending. Uncertainty regarding potential military action in Iraq also poses an important risk to the outlook.

Evolution of the Average Private Sector Forecasts for Canada

	2002	2003
	(per cent, unless otherwise indicated)	
Real GDP growth		
December 2001 budget	1.1	3.9
October 2002 update	3.4	3.5
Difference (percentage points)	2.3	-0.4
GDP inflation		
December 2001 budget	0.2	1.9
October 2002 update	1.1	2.3
Difference (percentage points)	0.9	0.4
Nominal GDP growth		
December 2001 budget	1.3	5.9
October 2002 update	4.6	5.9
Difference (percentage points)	3.3	0.0
Employment growth		
December 2001 survey[1]	0.2	1.8
October 2002 update	1.9	2.1
Difference (percentage points)	1.7	0.3
Unemployment rate		
December 2001 survey[1]	7.8	7.3
October 2002 update	7.6	7.1
Difference (percentage points)	-0.2	-0.2
3-month Treasury bill rate		
December 2001 budget	2.4	4.0
October 2002 update	2.6	3.9
Difference (percentage points)	0.2	-0.1
10-year government bond rate		
December 2001 budget	5.5	5.9
October 2002 update	5.3	5.5
Difference (percentage points)	-0.2	-0.4

[1] Private sector forecasts for employment growth and the unemployment rate were not available at the time of the December 2001 budget. These data are from the December 2001 Department of Finance survey of private sector forecasters, which was completed after the budget.

Sources: December 2001 budget: December 2001 consultation with private sector forecasters. October 2002 update: September 2002 Department of Finance survey of private sector forecasters.

Annex 2

Canada's Fiscal Progress

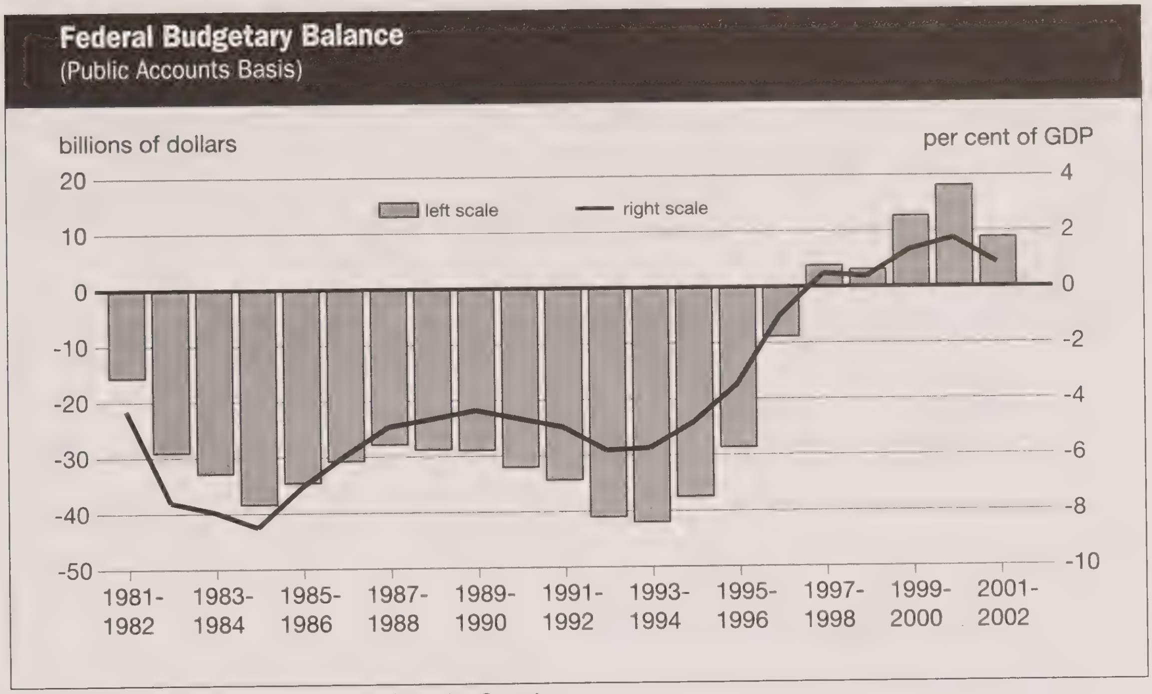
Highlights

- *The federal government recorded a budgetary surplus of $8.9 billion 2001-02. This marks the fifth consecutive year the federal budget has been in surplus.*
- *Net debt – the accumulation of deficits and surpluses since Confederation – has been reduced by $46.7 billion to $536.5 billion. This reduction in debt, coupled with Canada's sustained economic growth, has resulted in a significant decline in the federal debt-to-GDP (gross domestic product) ratio, from its peak of 70.9 per cent in 1995-96 to 49.1 per cent in 2001-02.*
- *Federal market debt – the debt issued on credit markets – has declined by $34.6 billion. It now stands at $442.3 billion. Market debt as a percentage of GDP has declined to 40.5 per cent from the peak of 57.9 per cent in 1995-96.*
- *The revenue-to-GDP ratio fell to 15.9 per cent in 2001-02, down sharply from 16.9 per cent in 2000-01. It is at its lowest level since 1993-94. The decline in 2001-02 primarily reflects the impact of the $100-billion tax reduction initiatives announced and legislated in the October 2000* Economic Statement and Budget Update.
- *The amount of every revenue dollar collected by the federal government used to pay interest on the public debt declined to 21.8 cents in 2001-02, down from 36 cents in 1995-96, and is now at its lowest level since 1979-80.*
- *Federal program spending increased by 6.1 per cent in 2001-02. Over 80 per cent of this increase was attributable to increased transfers to the provinces and territories under the Agreements on Health Renewal and Early Childhood Development reached by first ministers in September 2000 and to higher employment insurance benefits. Program spending stood at 11.6 per cent of GDP in 2001-02, compared to 16.5 per cent in 1993-94.*

- *The aggregate provincial-territorial budget is expected to record a small deficit in 2001-02. However, six provinces and two territories are expected to report a balanced budget or surplus in 2001-02.*

- *On a total government basis, Canada recorded a surplus of 2.4 per cent of GDP in 2001, the largest among the Group of Seven (G-7) countries. The Organisation for Economic Co-operation and Development (OECD) estimates that Canada will be the only G-7 country in surplus in 2002 at the total government sector level. Since 1995 Canada's total government sector has achieved the largest reduction in net debt among the G-7 countries and its net debt-to-GDP ratio is now below the G-7 average.*

Fifth consecutive budget surplus



Sources: *Public Accounts of Canada* and Statistics Canada.

- There was a budgetary surplus of $8.9 billion in 2001-02. The federal government has now achieved five consecutive annual surpluses, including revised surpluses of $3.8 billion in 1997-98, $3.1 billion in 1998-99, $12.7 billion in 1999-2000 and $18.1 billion in 2000-01.[1]
- As a result of these surpluses, net debt has been reduced by $46.7 billion since 1997-98.
- As a percentage of GDP, the budgetary surplus was 0.8 per cent in 2001-02.
- This achievement reverses a trend of more than a quarter of a century of uninterrupted government deficits. Five consecutive surpluses have not been recorded since 1951-52.

[1] Budgetary surpluses for 1997-98 to 2000-01 were revised to reflect the misclassification of mutual fund trust capital gain refunds. For more information, see the *Annual Financial Report of the Government of Canada* (fiscal year 2001-02).

Better-than-expected fiscal outcome for 2001-02 due to lower program spending and public debt charges, and higher revenues

Table 2.1
Financial Highlights: Comparison to December 2001 Budget

	(billions of dollars)
December 2001 budget projected surplus	1.5
Changes[1]	
Program spending	
Major transfers to persons	0.3
Major transfers to other levels of government	0.5
Direct program spending	3.2
Total spending	3.9
Public debt charges	1.5
Budgetary revenues	
Personal income tax	3.5
Corporate income tax	0.4
Other income tax	-1.0
Employment insurance premium revenues	0.2
Excise taxes and duties	-0.6
Non-tax revenues	-0.5
Total revenues	2.0
Net change	7.4
Outcome for 2001-02	8.9

Note: Numbers may not add due to rounding.

[1] A positive number implies an improvement in the budgetary balance. A negative number implies a deterioration in the budgetary balance.

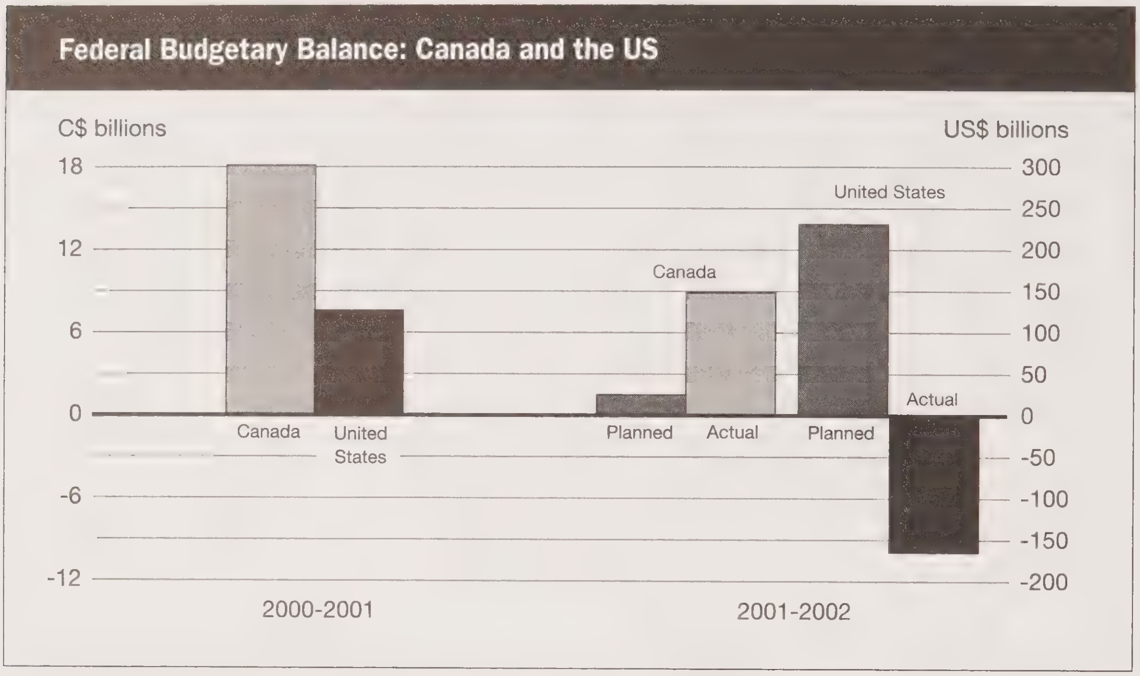
- The budgetary surplus of $8.9 billion in 2001-02 was $7.4 billion above the surplus of $1.5 billion estimated in the December 2001 budget.
- Program spending was $3.9 billion lower than estimated in the December 2001 budget, primarily reflecting lower direct program spending. As a result, program spending advanced by 6.1 per cent, considerably lower than the 9.4 per cent estimated in the budget.
  - Major transfers to persons were $0.3 billion lower due to lower-than-expected employment insurance benefits.
  - Major transfers to other levels of government were $0.5 billion below the December 2001 budget estimates, reflecting lower equalization entitlements and higher recoveries under the Alternative Payments for Standing Programs.

- Direct program spending (subsidies and other transfers, expenditures related to Crown corporations, defence spending, and operating and capital expenditures of non-defence departments and agencies) was $3.2 billion lower than expected due to lower-than-expected liabilities at year-end and a higher-than-assumed lapse in spending authority.

- Public debt charges were $1.5 billion lower than expected, primarily due to a change in determining interest accrued to the public sector pension accounts.

- Budgetary revenues were $2.0 billion higher than estimated in the December 2001 budget, primarily due to stronger-than-expected economic growth in the fourth quarter of 2001 and first quarter of 2002. At the time of the December 2001 budget, most forecasters were expecting economic weakness to continue in the fourth quarter, with only modest growth in the first quarter of 2002.
  - Personal income tax revenues were $3.5 billion higher than expected, reflecting strong employment gains recorded in the first quarter of 2002 and adjustments related to overpayments to the tax collection accounts.
  - The higher-than-estimated corporate income tax revenues were entirely attributable to the lower-than-expected take-up of the December 2001 budget proposal to allow small businesses to defer for six months their corporate income tax instalments for the months of January, February and March 2002. The budget estimated the cost of this initiative at $2.0 billion. Preliminary indications are that the take-up of the initiative amounted to about $600 million.
  - Other income taxes were $1.0 billion lower due to a correction of a consolidation adjustment related to refundable taxes withheld from the federal Retirement Compensation Arrangements Account that were previously credited to tax revenues.
  - Excise taxes and duties were $0.6 billion lower, primarily due to lower goods and services tax at year-end.
  - Non-tax revenues were $0.5 billion lower due entirely to a classification change, whereby "refunds from previous years' expenditures," which in the past were included as part of "other non-tax revenues," are now netted against program spending. This has the effect of lowering both budgetary revenues and program spending by equivalent amounts, with no impact on the overall budgetary balance.

Canada remained in surplus in 2001-02 while the US went into deficit



Sources: Canada: Department of Finance; US: Office of Management and Budget.

- In 2000-01 both Canada and the United States recorded surpluses.
- In the December 2001 budget the federal government estimated a surplus of $1.5 billion for 2001-02. With better-than-expected economic growth in the last six months of the fiscal year and lower-than-expected expenditure growth, the final outcome was a surplus of $8.9 billion.
- In contrast, the US Administration, in its original budget plan for fiscal year 2001-02, forecast a surplus of US$231 billion. However, the final result was a deficit of US$159 billion – a swing of almost US$390 billion.

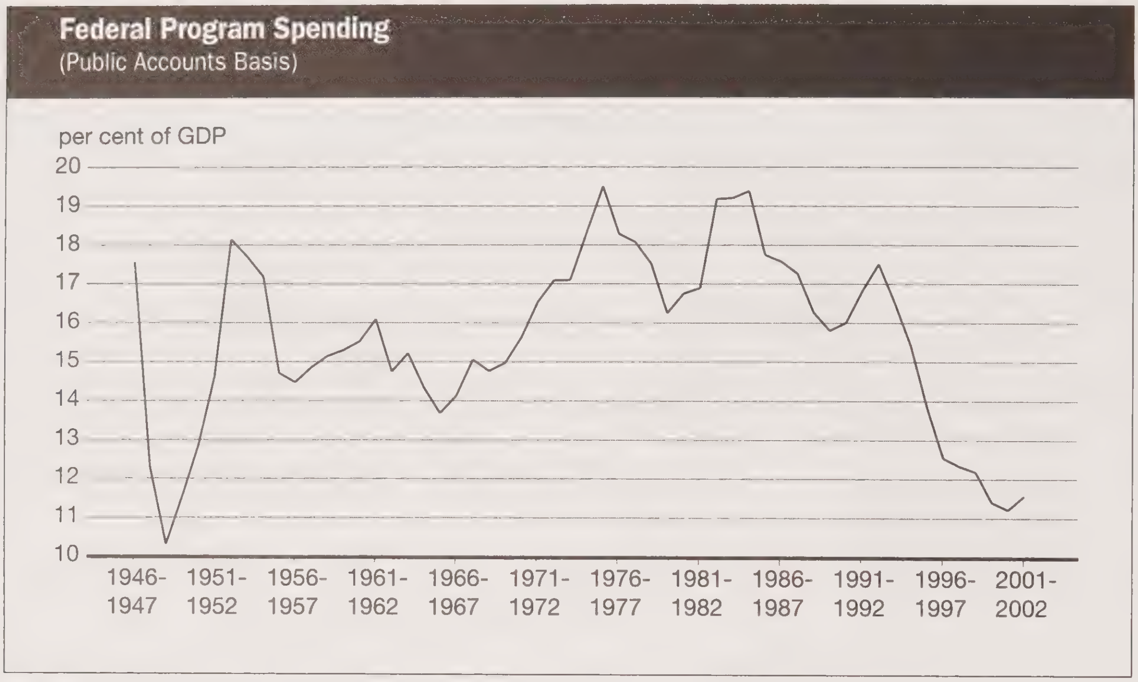
Fiscal progress between 1993-94 and 2001-02

Table 2.2
Change in the Federal Budgetary Balance Relative to the Size of the Economy

	1993-94	2001-02	Change	Contribution
		(per cent of GDP)		(per cent)
Budgetary revenues	15.9	15.9	0.0	0.0
Program spending	16.5	11.6	-4.9	74.2
Public debt charges	5.2	3.5	-1.7	25.8
Budgetary balance	-5.8	0.8	6.6	100.0

- The contribution of changes in revenues and expenditures to the improvement in the budgetary balance is best illustrated by looking at the evolution of budgetary revenues, program spending and public debt charges, and the resulting budgetary balance, as a share of the economy.
- Between 1993-94 and 2001-02 the budgetary balance went from a deficit of 5.8 per cent of GDP to a surplus of 0.8 per cent – a turnaround of 6.6 percentage points.
- Nearly 75 per cent of this improvement was attributable to the decline in program spending as a percentage of GDP. This primarily reflected the impact of discretionary actions taken since 1993.
- Reductions in the stock of interest-bearing debt, a decline in the average effective interest rate on that debt, and a change in the accounting for interest costs related to public sector pension plans resulted in a decline in public debt charges as a percentage of GDP. This decline accounted for just over 25 per cent of the improvement in the overall budgetary balance.
- Over this period the revenue-to-GDP ratio was unchanged at 15.9 per cent.

Program spending as a share of GDP up slightly in 2001-02



Sources: *Public Accounts of Canada* and Statistics Canada.

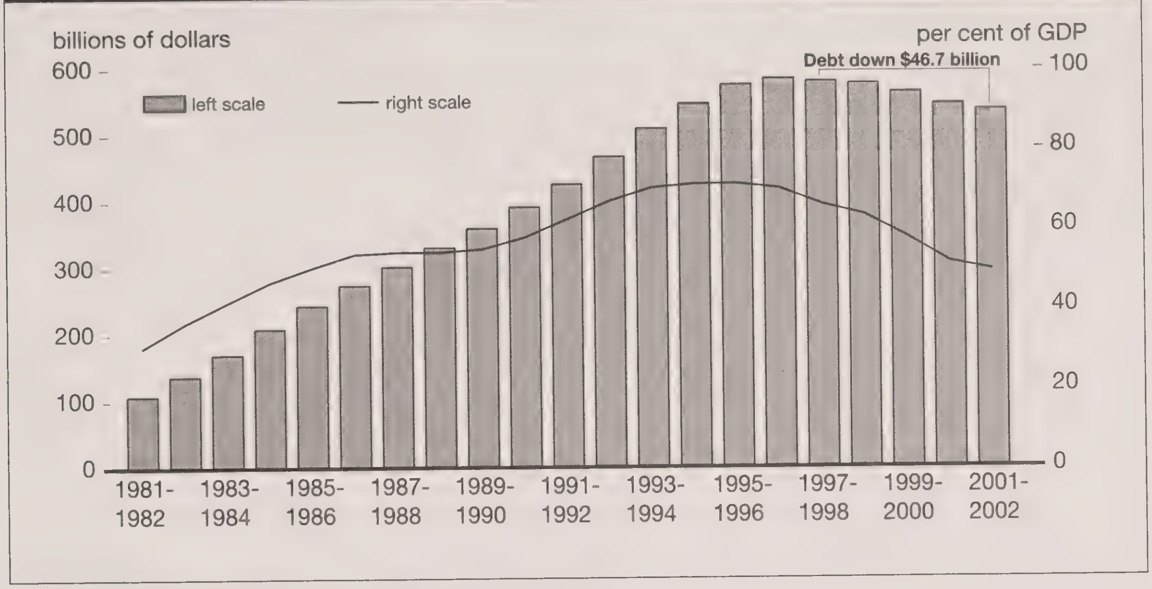
- Program spending increased $7.3 billion, or 6.1 per cent, to $126.7 billion in 2001-02. Of this increase, over 80 per cent went to higher cash transfers to provinces and territories under the Canada Health and Social Transfer and to increased employment insurance benefits. The increase in employment insurance benefits was attributable to a rise in regular benefits resulting from an increase in the number of unemployed, as well as to higher parental benefits, reflecting the doubling of parental leave from six months to one year.

- Between 1997-98 and 2001-02 program spending increased at an average annual rate of 3.8 per cent. This compares to average annual growth of 2.8 per cent in the population and inflation, and 5.5 per cent in nominal GDP, over this period.

- As a percentage of GDP, program spending increased to 11.6 per cent in 2001-02, up from 11.2 per cent in 2000-01. The program spending-to-GDP ratio is nearly 5 percentage points below its level in 1993-94.

Debt-to-GDP ratio declines for the sixth consecutive year

Federal Net Debt
(Public Accounts Basis)



Sources: *Public Accounts of Canada* and Statistics Canada.

- The debt-to-GDP ratio is generally recognized as the most appropriate measure of the debt burden, as it measures the debt relative to the ability of the Government and the nation's taxpayers to finance it.
- The debt-to-GDP ratio fell to 49.1 per cent in 2001-02, the first time it has been under 50 per cent since 1985-86. It has come down nearly 22 percentage points from its peak of 70.9 per cent in 1995-96.

Net debt reduced by $46.7 billion over the last five years

Table 2.3
Federal Government Financial Assets and Liabilities

	1996-97	2001-02	Change
		(billions of dollars)	
Financial assets			
Cash and accounts receivable	13.4	16.8	3.4
Foreign exchange accounts	26.8	52.0	25.2
Net loans, investments and advances	17.3	18.7	1.5
Total financial assets	57.5	87.6	30.1
Gross liabilities			
Interest-bearing debt			
Market debt			
Payable in Canadian currency	453.8	415.2	-38.6
Payable in foreign currencies	23.0	27.0	4.0
Total	476.9	442.3	-34.6
Public sector pension and other accounts	123.7	141.2	17.5
Total interest-bearing debt	600.6	583.4	-17.1
Other liabilities	40.1	40.7	0.6
Gross liabilities	640.7	624.1	-16.4
Net debt	**583.2**	**536.5**	**-46.7**

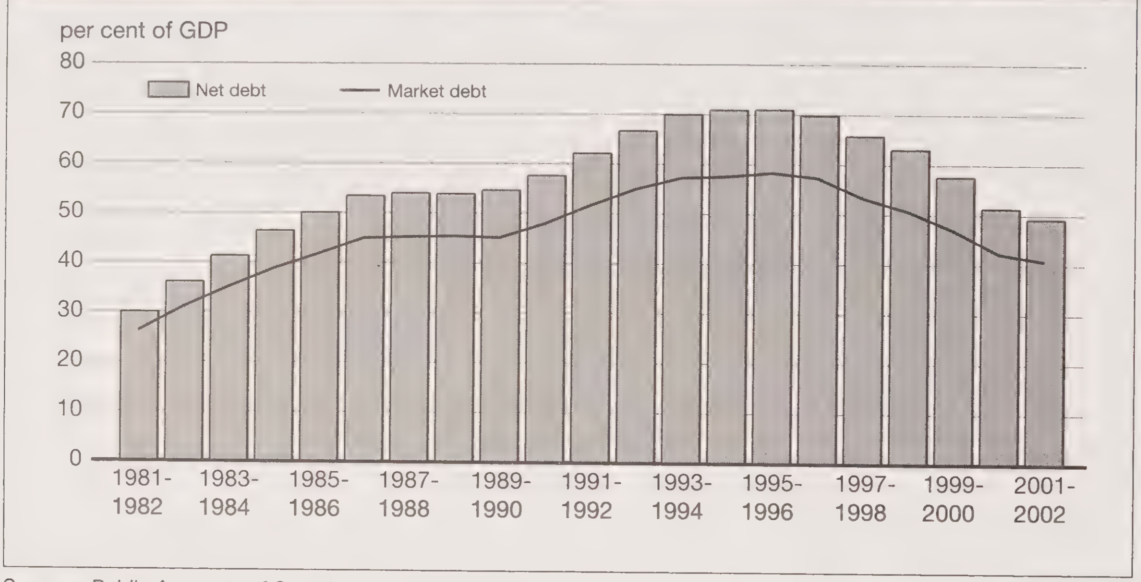
Note: Numbers may not add due to rounding.

- The five consecutive annual surpluses have reduced the stock of federal net debt by $46.7 billion since 1996-97. The net debt was $536.5 billion in 2001-02.
- Net debt consists of financial assets and gross liabilities.
- Financial assets consist of cash, accounts receivable, assets in the foreign exchange account, investment in Crown corporations and loans to other governments. These have increased by $30.1 billion since 1996-97. This increase is largely attributable to higher international reserves held in the Exchange Fund Account. The purpose of this account is to aid in the control and protection of the external value of the Canadian dollar by acquiring or selling assets, as required. The increase over the last five years reflects the Government's announcement in the 1995 and 1998 budgets to bring the level of Canada's international reserves more in line with those of other countries. Net gains on these assets are credited to budgetary revenues (return on investments), although borrowing costs associated with acquiring these assets are part of public debt charges.

- Gross liabilities include the Government's obligations with respect to interest-bearing debt and other liabilities, such as accounts payable. Interest-bearing debt consists of market debt and the Government's liabilities to federal employee pension plans and other accounts. Gross liabilities have declined by $16.4 billion since 1996-97, with interest-bearing debt down $17.1 billion and other liabilities up $0.6 billion. Within interest-bearing debt:
  - Market debt, consisting of debt issued on credit markets in the form of Government of Canada bonds, Canada Savings Bonds and Treasury bills, for example, declined by $34.6 billion between 1996-97 and 2001-02: debt payable in Canadian currency declined by $38.6 billion while debt payable in foreign currencies increased by $4.0 billion. The latter is solely used for exchange fund operations.
  - Liabilities to the federal government employees' pensions and other accounts increased by $17.5 billion over the last five years.

Decline in market debt mirrors decline in net debt

Federal Net Debt and Market Debt
(Public Accounts Basis)



Sources: *Public Accounts of Canada* and Statistics Canada.

- The decline in market debt of $34.6 billion since 1996-97 has resulted in a market debt-to-GDP ratio of 40.5 per cent in 2001-02. The decline in market debt, which is the single largest component of net debt, mirrors the rapid fall in the net debt-to-GDP ratio over the last five years.

Financial source of $4.7 billion in 2001-02

Table 2.4
Federal Budgetary Surplus and Financial Source

	2001-02
	(billions of dollars)
Budgetary surplus	8.9
Non-budgetary transactions	
Loans, investments and advances	-0.1
Pensions and other accounts	-1.7
Other transactions	-2.4
Total	-4.2
Financial source (excluding foreign exchange transactions)	4.7

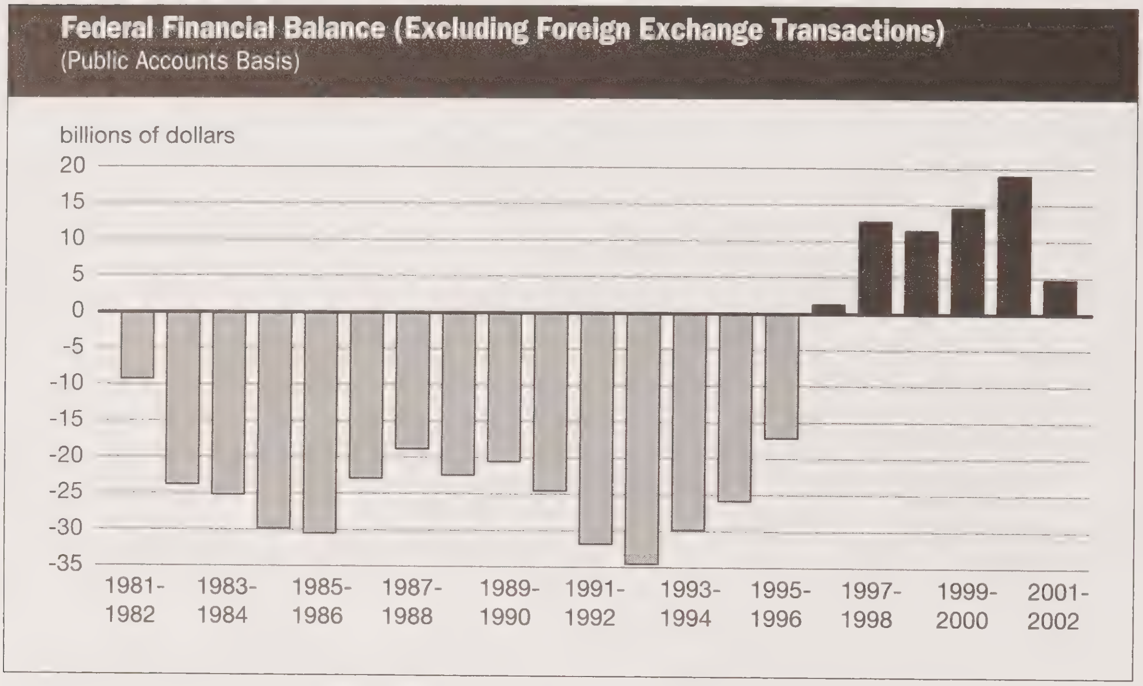
- The Government's fiscal anchor is the budgetary balance. This measure is presented on a modified accrual basis of accounting, recording government liabilities when they are incurred, regardless of when the cash payment is made, and recording tax revenues only when cash is received. The budgetary balance covers only those activities over which the Government has legislative control.

- The federal government's cash position is referred to as the financial requirements/source, which measures the difference between cash received and cash disbursed. It differs from the budgetary balance in that it includes transactions in loans, investments and advances, federal government employee pension accounts, other accounts, changes in financial assets and liabilities, as well as the conversion from accrual to cash accounting. The net change in these activities is included as part of non-budgetary transactions.

- Non-budgetary transactions produced a net requirement of $4.2 billion. Loans, investments and advances recorded a net requirement of $0.1 billion, as borrowings for the Canada Student Loans Program were virtually offset by repayments in other areas. Pensions and other accounts recorded a net requirement of $1.7 billion, primarily attributable to the transfer of applicable pension assets to those Crown corporations establishing their own pension plans. Other transactions provided a net requirement of $2.4 billion due to the cash payments of liabilities incurred in previous fiscal years.

- As a result, with a budgetary surplus of $8.9 billion and a net requirement of $4.2 billion from non-budgetary transactions, there was a financial source, excluding foreign exchange transactions, of $4.7 billion in 2001-02.

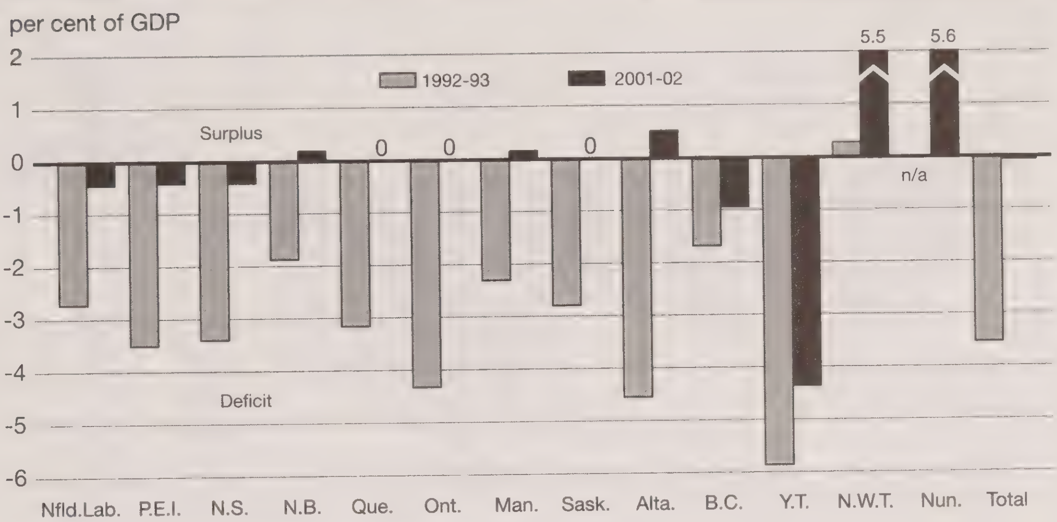
Financial source recorded for the sixth consecutive year



- Financial sources have now been recorded in each of the past six years. This is in contrast to the large financial requirements observed from the mid-1970s through the mid-1990s.

A majority of the provinces and territories reported budgetary surpluses in 2001-02

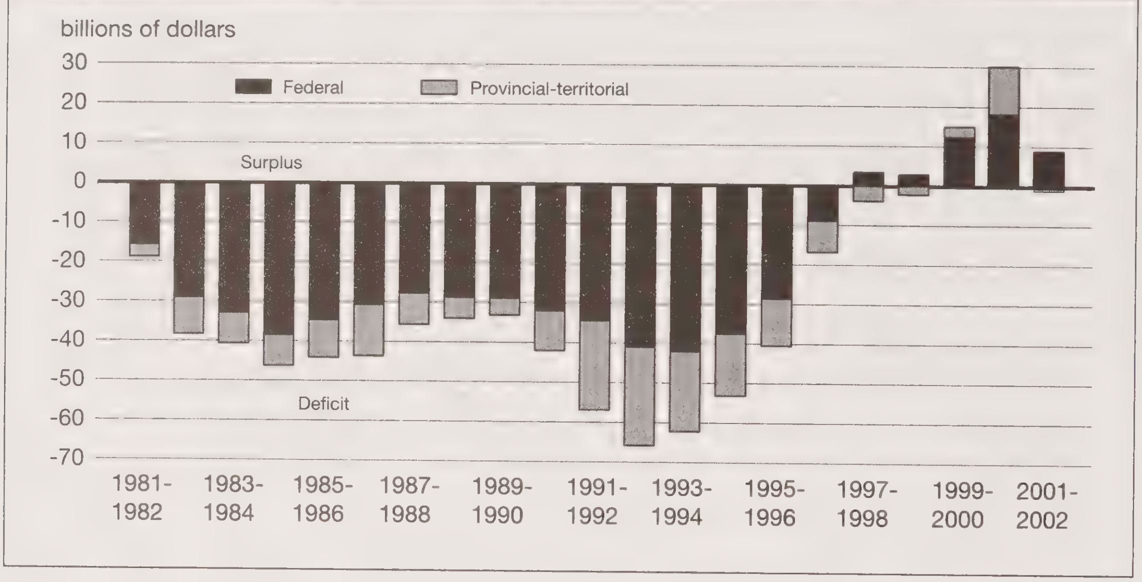
Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



- Like the federal government, the provinces and territories have made substantial progress in restoring their fiscal health.
- Six provinces and two territories are estimated to have recorded a balanced budget or surplus in 2001-02. Preliminary estimates suggest that the provincial-territorial government sector, as a whole, will report a deficit of about $300 million in 2001-02. However, final provincial-territorial financial results could turn this into a small surplus.
- This represents a substantial improvement from the situation in 1992-93, when all but one of the then 12 provincial-territorial government budgets (Northwest Territories) were in deficit.

The combined federal-provincial-territorial government sector recorded a surplus in 2001-02 for the fourth consecutive year

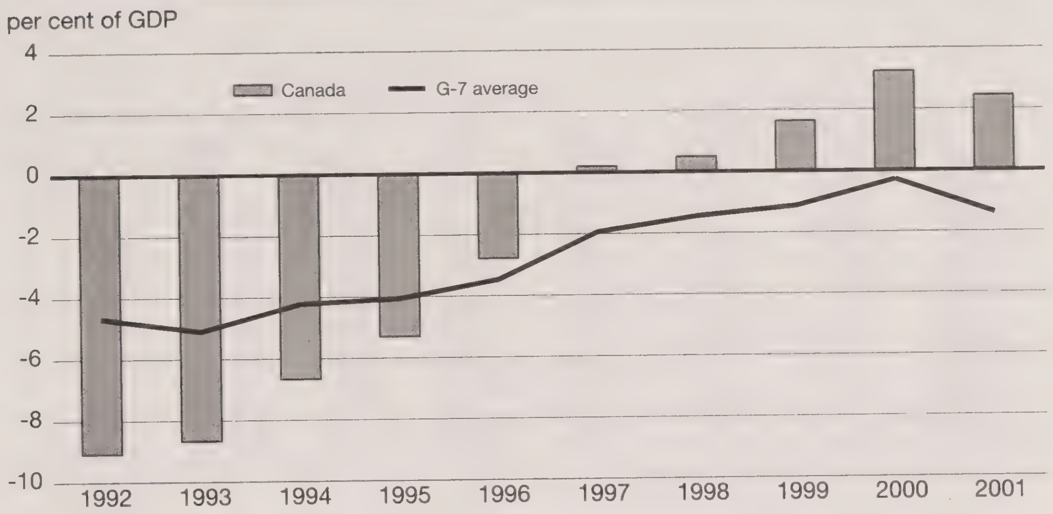
Federal and Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



- The federal-provincial-territorial government sector is expected to record an aggregate surplus of $8.6 billion in 2001-02. This is the fourth consecutive year that this sector has been in surplus.

Canada's financial balance has improved significantly compared to the G-7 average

Total Government Financial Balances: Canada and the G-7
(National Accounts Basis)



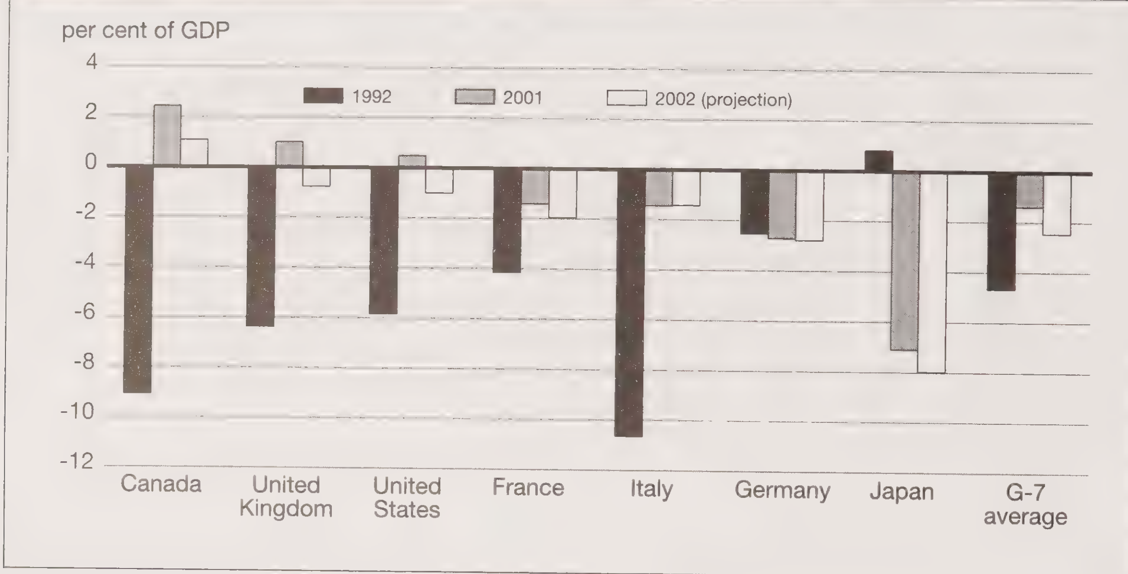
Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- Canada's total government sector financial position,[1] measured on a National Accounts basis (the measure commonly used to make comparisons across countries), has shown a similar substantial improvement since the early 1990s.
- Measured on this internationally comparable basis, the total government deficit peaked at 9.1 per cent of GDP in 1992, compared to the G-7 average deficit-to-GDP ratio of 4.7 per cent that same year.
- By 1997, however, fiscal improvements at all levels of government enabled Canada's total government sector to post a surplus. Since that time Canada has consistently recorded the highest financial surplus of all G-7 countries, relative to the size of the economy.
- In 2001 Canada's total government sector surplus stood at 2.4 per cent of GDP, compared to an average deficit of 1.4 per cent of GDP in the G-7 countries.

[1] Includes federal, provincial-territorial and local governments as well as the Canada Pension Plan and Quebec Pension Plan.

Canada has achieved the largest improvement in its financial balance of any G-7 country

Total Government Financial Balances in G-7 Countries
(National Accounts Basis)

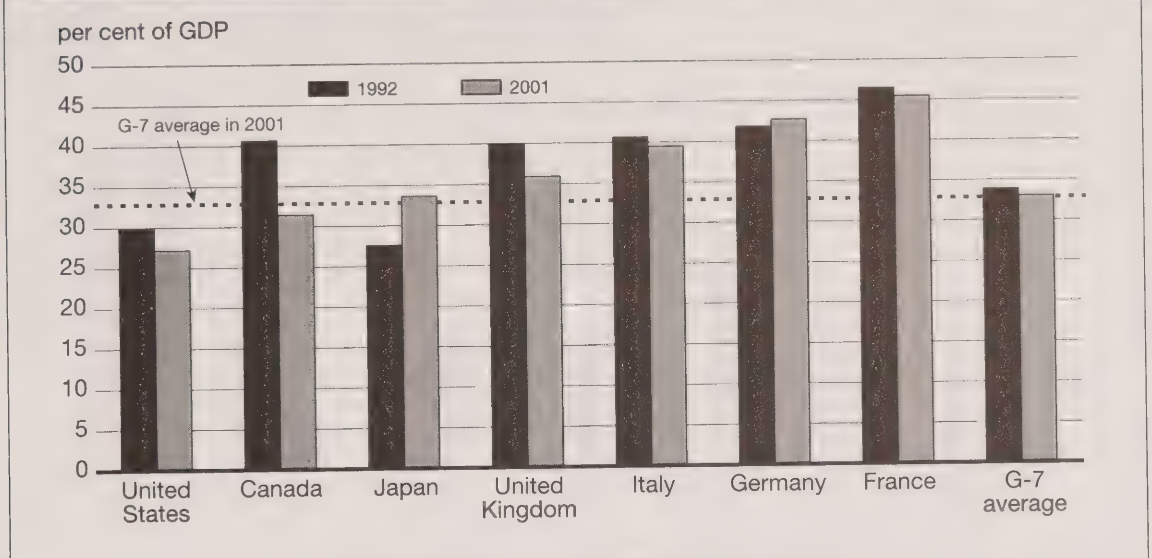


Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- At the total government sector level, Canada made the greatest fiscal improvement of the G-7 countries from 1992 to 2001.
- In 1992 Canada had the second highest deficit of the G-7 countries in relation to GDP, whereas it posted the highest financial surplus relative to GDP in 2001. Over this period Canada's financial balance registered a turnaround of 11.5 percentage points.
- For 2002 the OECD projects that Canada will be the only G-7 country to record a surplus.

Canada's program spending as a share of GDP has been reduced to below the G-7 average

Total Government Program Spending in G-7 Countries
(National Accounts Basis)

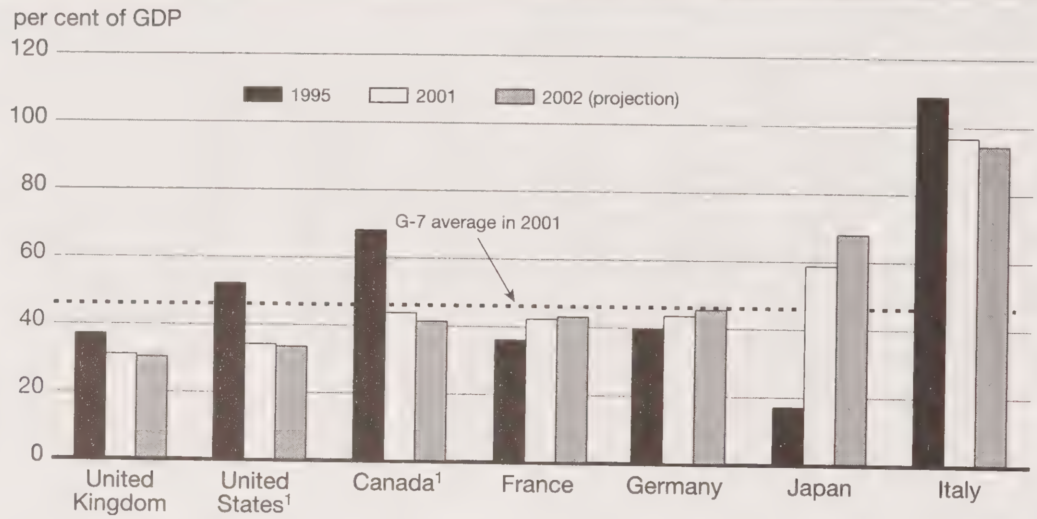


Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- The rapid turnaround in Canada's financial position, as a percentage of GDP, is attributable in large part to a sharp reduction in program spending, i.e. all expenditures less gross debt charges.
- Between 1992 and 2001 Canada's total government program spending as a share of GDP was reduced by 9.2 percentage points, again a greater reduction than in any other G-7 country.
- Indeed, Canada's total government sector program spending, as a percentage of GDP, is now lower than in all other G-7 countries, with the exception of the US.

Canada has recorded the largest decline in the net debt-to-GDP ratio among the G-7 countries

Total Government Net Debt in G-7 Countries
(National Accounts Basis)



[1] Excludes government employee pension liabilities in order to be more comparable with other countries' debt measures.
Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- Over the last six years Canada's total government sector has achieved the largest decline in the net debt-to-GDP ratio among the G-7 countries. Between 1995 and 2001 the ratio was reduced by 24.4 percentage points.
- As a result, Canada's total government net debt-to-GDP ratio is now below the G-7 average.
- According to the OECD, with Canada's economic growth expected to lead the G-7 countries this year and with a total government financial surplus expected, only the United Kingdom and the United States will have a lower net debt-to-GDP ratio than Canada in 2002.

Annex 3

Private Sector Five-Year Economic and Fiscal Projections

Highlights

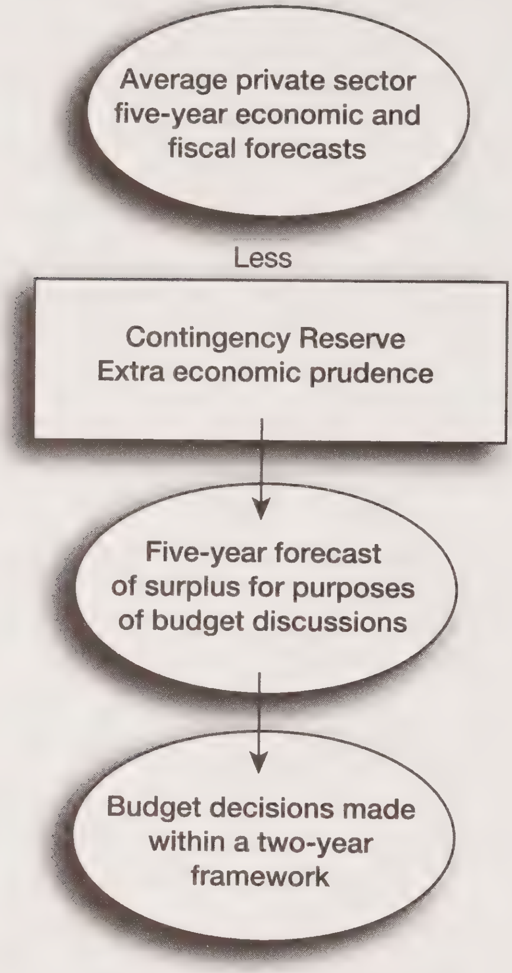
- *The Department of Finance meets each fall with the chief economists of the major chartered banks and three private sector economic forecasting firms. The objective of this exercise, which was initiated in 1999, is to agree on a set of economic assumptions for planning purposes, which the three forecasting firms then use to develop status quo fiscal projections of the budgetary balance for the current fiscal year and each of the next five years.*
- *However, because of the greater degree of uncertainty associated with longer-term projections, budget decisions are made on a rolling two-year horizon.*
- *Prudence is an essential element of budget planning. Therefore, in order to arrive at an estimate of the fiscal surplus for planning purposes, the average fiscal surplus projections are adjusted to include:*
  - *$3 billion each year as a Contingency Reserve to guard against unforeseen circumstances. As usual, any year-end surplus goes to pay down debt; and*
  - *economic prudence to provide further assurance against going back into deficit.*
- *After subtracting the Contingency Reserve, the economic prudence and the impact of new policy decisions since the December 2001 budget from the average private sector forecast of the surplus, the surplus for planning purposes is estimated at $1.0 billion in 2002-03, $3.1 billion in 2003-04, $3.5 billion in 2004-05, $6.8 billion in 2005-06, $10.5 billion in 2006-07 and $14.6 billion in 2007-08.*

- *The smaller projections of the fiscal surplus in the short term reflect the lagged impacts of the slowdown in economic activity in 2001 on tax revenues, as well as the effects of the Agreements on Health Renewal and Early Childhood Development signed by first ministers in September 2000 and the $100-billion Five-Year Tax Reduction Plan, which fully matures in 2004. Thereafter larger fiscal-planning surpluses are projected.*

Framework for budget planning

- Since 1993, the Government's approach to budget planning has involved a number of important steps.
- The first step involves using private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a regular basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and leading economic forecasting firms. A key purpose of these consultations is to assess the risks associated with using the average of private sector economic forecasts for budget-planning purposes.
- The second step involves using these economic assumptions to develop status quo fiscal projections.
  - Since 1999, each fall the major private sector economic forecasting firms develop detailed status quo fiscal projections, on a National Accounts basis, for each of the next five years, based on tax and spending policies in place at that time, using the average of the private sector economic forecasts.
  - These forecasts are then translated into Public Accounts projections by the Department of Finance, in consultation with the private sector economic forecasting firms.
- The third step involves including in these fiscal projections for budget-planning purposes:
  - $3 billion each year in the Contingency Reserve to guard against unforeseen circumstances. As usual, any year-end surplus goes to pay down the public debt; and
  - an extra degree of economic prudence to provide further assurance against falling back into deficit.

Summary: framework for fall update and budget



- It is the view of the private sector economic advisory group that, for the purposes of public debate on policy options, a five-year time horizon is appropriate.
- However, it is also the view of the advisory group that great caution is warranted in the use of long-term projections as a basis for budget decisions. Therefore, budget decisions continue to be made on a rolling two-year horizon.

Assumptions underlying average private sector fiscal projections

Table 3.1
Average of Private Sector Economic Forecasts: September 2002 Survey

	2002	2003	2004-2008
		(per cent)	
Real GDP growth	3.4	3.5	3.0
GDP inflation	1.1	2.3	1.9
Nominal GDP growth	4.6	5.9	5.0
3-month Treasury bill rate	2.6	3.9	4.8
10-year government bond rate	5.3	5.5	5.8

Note: Based on a survey conducted by the Department of Finance in early September.
The number of respondents declines from 19 in 2003 to 6 in 2007 and 5 in 2008.

- As noted in Annex 1, average real gross domestic product (GDP) growth in the private sector survey of forecasters for the October 2002 update is 3.4 per cent in 2002 and 3.5 per cent in 2003. The average growth forecast over the 2004 to 2008 period is 3.0 per cent. GDP inflation is expected to average just under 2 per cent over the 2004 to 2008 period. As a result, nominal GDP growth is forecast to average 5.0 per cent over the same period. Short-term interest rates are expected to rise through to 2004. The average of private sector forecasts anticipates relatively flat interest rates between 2004 and 2008, along with consumer price inflation at the mid-point of the official target band of 1 to 3 per cent.

- Based on the private sector survey of forecasters for the October 2002 update, the three forecasting firms derived projections of the major components of the budgetary balance on a National Accounts basis, which were then converted into Public Accounts projections by the Department of Finance. The projections are based on the following assumptions:
  - The projections include the impact of the $100-billion Five-Year Tax Reduction Plan as set out in the October 2000 *Economic Statement and Budget Update*, the $23.4-billion Agreements on Health Renewal and Early Childhood Development signed by first ministers in September 2000, and the policy decisions announced in the December 2001 budget. In addition, fiscal projections have been adjusted, where appropriate, to take into account the impact of the final fiscal results for 2001-02 and those for the first five months of 2002-03.
  - The employment insurance premium rate assumptions are those used in the December 2001 budget – $2.20 (employee rate per $100 of insurable earnings) for 2002, declining to $2.00 by 2004.
  - The projections of public debt charges assume that the Contingency Reserve is not required and is applied each year to reducing the net public debt.

October 2002 status quo fiscal outlook – Average of private sector fiscal projections

Table 3.2
Surpluses for Purposes of Fiscal Planning

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
			(billions of dollars)			
Average of private sector fiscal projections	**5.0**	**8.9**	**9.7**	**14.1**	**18.3**	**22.8**
Initiatives announced since the December 2001 budget						
Canada Strategic Infrastructure Fund	0.1	0.1	0.3	0.5	0.5	0.4
Africa Fund	0.1	0.2	0.1	0.1		
Support for agriculture	0.7	1.3	0.8	0.8	0.8	0.8
Softwood lumber assistance	0.1	0.2				
Total	1.0	1.8	1.2	1.3	1.3	1.2
Average of private sector projections adjusted for policy initiatives	4.0	7.1	8.5	12.8	17.0	21.6
Prudence						
Economic prudence		1.0	2.0	3.0	3.5	4.0
Contingency Reserve	3.0	3.0	3.0	3.0	3.0	3.0
Total	3.0	4.0	5.0	6.0	6.5	7.0
Surplus for planning purposes	**1.0**	**3.1**	**3.5**	**6.8**	**10.5**	**14.6**

Note: Numbers may not add due to rounding.

- The fiscal surplus for planning purposes for the upcoming budget is derived from the average of the private sector fiscal projections.
- The average of the three forecasting firms' fiscal projections, converted to a Public Accounts basis but prior to adjusting for the Contingency Reserve, economic prudence and new policy initiatives, results in a fiscal surplus of \$5.0 billion in 2002-03, \$8.9 billion in 2003-04, \$9.7 billion in 2004-05, \$14.1 billion in 2005-06, \$18.3 billion in 2006-07 and \$22.8 billion in 2007-08.
- These projections are then adjusted to include the impact of policy decisions since the December 2001 budget and prudence.

- The net fiscal impact of the policy initiatives since the December 2001 budget amounts to $1.0 billion in 2002–03, $1.8 billion in 2003–04 and about $1.2 billion per year thereafter.
  - In the December 2001 budget the Canada Strategic Infrastructure Fund (with a minimum federal contribution of $2 billion) and the Africa Fund ($500 million) were announced. The original intention was that these initiatives would be set up as arm's-length organizations, funded from the 2001–02 surplus funds at year-end. However, on February 4, 2002, the Government announced that these initiatives would be part of regular program spending, with the costs recorded in the year the expenditures are made.
  - In September 2002 the federal, provincial and territorial governments agreed in principle on a long-term action plan for an agricultural policy framework, with the objective of making Canada the world leader in food safety, innovation and environmentally responsible production. In addition, further income assistance is provided over the next two years to assist farmers affected by current drought conditions. The federal cost amounts to $5.3 billion over the next six years.
  - Assistance has also been provided to workers and communities affected by the softwood lumber dispute with the United States.

- The projections are adjusted to reflect the economic prudence and Contingency Reserve.
  - In the December 2001 budget the unforeseen circumstances of both the global economic slowdown and the terrorist attacks of September 11th created fiscal pressures, which needed to be addressed. Given the surplus available at that time, the Government decided to use the economic prudence and part of the Contingency Reserve for each year of the December 2001 budget plan. However, the Government indicated that it would rebuild the economic prudence and Contingency Reserve as soon as possible.
  - The full Contingency Reserve of $3 billion per year has been re-established.
  - In addition, for planning purposes, the economic prudence has been set at $1 billion in 2003–04, $2 billion in 2004–05, $3 billion in 2005–06, $3.5 billion in 2006–07 and $4 billion in 2007–08.

- Therefore, after these adjustments the fiscal surplus for planning purposes is $1.0 billion in 2002–03, $3.1 billion in 2003–04, $3.5 billion in 2004–05, $6.8 billion in 2005–06, $10.5 billion in 2006–07 and $14.6 billion in 2007–08.

October 2002 status quo fiscal outlook – Average of private sector fiscal projections

Table 3.3
Summary Statement of Transactions

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	(billions of dollars)						
Budgetary transactions							
Budgetary revenues	173.3	173.9	184.1	191.9	201.5	211.2	221.0
Program spending	126.7	134.3	140.7	146.6	152.4	158.0	163.6
Operating balance	46.6	39.6	43.4	45.2	49.1	53.2	57.4
Public debt charges	37.7	35.6	36.3	36.7	36.3	36.1	35.9
Budgetary surplus	8.9	4.0	7.1	8.5	12.8	17.0	21.6
Prudence							
Contingency Reserve		3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence			1.0	2.0	3.0	3.5	4.0
Total		3.0	4.0	5.0	6.0	6.5	7.0
Planning surplus		**1.0**	**3.1**	**3.5**	**6.8**	**10.5**	**14.6**
Per cent of GDP							
Budgetary revenues	15.9	15.2	15.2	15.1	15.1	15.0	15.0
Program spending	11.6	11.8	11.6	11.5	11.4	11.3	11.1
Public debt charges	3.5	3.1	3.0	2.9	2.7	2.6	2.4
Budgetary surplus	0.8	0.4	0.6	0.7	1.0	1.2	1.5
Net debt							
Assuming balanced budget	49.1	47.0	44.4	42.1	40.1	38.2	36.4
Assuming Contingency Reserve applied to debt reduction	49.1	46.7	43.9	41.4	39.2	37.1	35.2

Note: Numbers may not add due to rounding.
[1] Actual results.

- Table 3.3 sets out the fiscal projections based on the September 2002 survey of private sector economic projections to 2007-08.

- Adjusted for the policy decisions since the December 2001 budget and for the Contingency Reserve, the surplus for planning purposes is $1.0 billion for 2002-03. The outlook for 2002-03 is consistent with the fiscal results for the first five months of 2002-03. For the period April to August 2002 there was a budgetary surplus of $4.6 billion, down $6.8 billion from the surplus of $11.4 billion reported in the same period of 2001-02. Given the seasonal pattern of revenues and spending over the balance of the fiscal year, this surplus should be reduced to an estimated $4.0 billion by year-end. Excluding the $3-billion Contingency Reserve results in a planning surplus of $1.0 billion for 2002-03. The fiscal outlook for the current fiscal year is affected by the lagged impact of the economic slowdown in 2001, as significantly higher personal and corporate income tax refunds related to lower earnings and losses in 2001 are depressing the growth in budgetary revenues in 2002-03.

- Thereafter somewhat larger fiscal-planning surpluses are projected. However, they remain constrained through 2004-05, reflecting the impact of the $100-billion tax reduction measures announced and legislated in the October 2000 *Economic Statement and Budget Update* and increased transfers to provinces and territories under the September 2000 Agreements on Health Renewal and Early Childhood Development reached by first ministers. Other budget measures, specifically the enhancements to employment insurance benefits and the security measures announced in the December 2001 budget, also impact on the fiscal outlook over the short term. After 2004-05 larger fiscal-planning surpluses are projected.

- The revenue-to-GDP ratio was estimated at 15.9 per cent in 2001-02, down significantly from 16.9 per cent in 2000-01. This primarily reflects the impact of tax reduction measures. It is expected to decline to 15.2 per cent in 2002-03 and to 15.1 per cent in 2004-05, as the Five-Year Tax Reduction Plan is fully put in place. The revenue ratio remains relatively stable thereafter.

- The program spending-to-GDP ratio increased to 11.6 per cent in 2001-02 from 11.2 per cent in 2000-01, primarily reflecting the impact of a slowing economy and the fiscal costs of the Agreements on Health Renewal and Early Childhood Development and changes to the employment insurance program. The ratio is projected to increase slightly in 2002-03, before again resuming its downward path.

- The net debt-to-GDP ratio stood at 49.1 per cent in 2001-02. If the Contingency Reserve is not needed and the $3 billion per year is used to reduce net debt, the net debt-to-GDP ratio would decline to under 40 per cent in 2005-06 and to about 35 per cent in 2007-08 – a decline of over half from its peak of 70.9 per cent in 1995-96.

Average private sector projections of budgetary revenues

Table 3.4
Budgetary Revenues – October 2002 Update: Private Sector Average

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	(millions of dollars)						
Income tax							
Personal income tax	83,790	82,300	88,156	92,365	97,987	103,260	108,788
Corporate income tax	24,013	22,500	24,765	25,706	26,478	27,301	28,038
Other income tax	3,035	3,750	3,942	4,060	4,136	4,236	4,316
Total income tax	110,838	108,550	116,862	122,131	128,601	134,796	141,142
Employment insurance revenues	17,980	18,246	18,081	18,307	19,129	19,996	20,948
Excise taxes/duties							
Goods and services tax	24,909	26,700	28,413	29,991	31,763	33,678	35,664
Customs import duties	3,018	3,170	3,202	3,382	3,532	3,668	3,775
Energy taxes	4,758	4750	4,873	4,975	5,101	5,213	5,335
Other excise taxes/duties	3,953	4,694	4,772	4,885	5,022	5,157	5,283
Total	36,638	39,314	41,260	43,234	45,418	47,717	50,057
Total tax revenues	165,456	166,110	176,203	183,672	193,148	202,509	212,147
Non-tax revenues							
Return on investments	5,892	5,739	5,774	6,011	6,145	6,374	6,523
Other non-tax revenues	1,967	2,092	2,142	2,192	2,242	2,292	2,342
Total	7,859	7,831	7,916	8,203	8,387	8,666	8,865
Total budgetary revenues	173,315	173,941	184,119	191,875	201,535	211,175	221,012
Per cent of GDP							
Personal income tax	7.7	7.2	7.3	7.2	7.3	7.4	7.4
Corporate income tax	2.2	2.0	2.0	2.0	2.0	1.9	1.9
Employment insurance revenues	1.6	1.6	1.5	1.4	1.4	1.4	1.4
Goods and services tax	2.3	2.3	2.4	2.4	2.4	2.4	2.4
Other excise	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Tax revenues	15.1	14.5	14.6	14.4	14.4	14.4	14.4
Non-tax revenues	0.7	0.7	0.7	0.6	0.6	0.6	0.6
Total	15.9	15.2	15.2	15.1	15.1	15.0	15.0

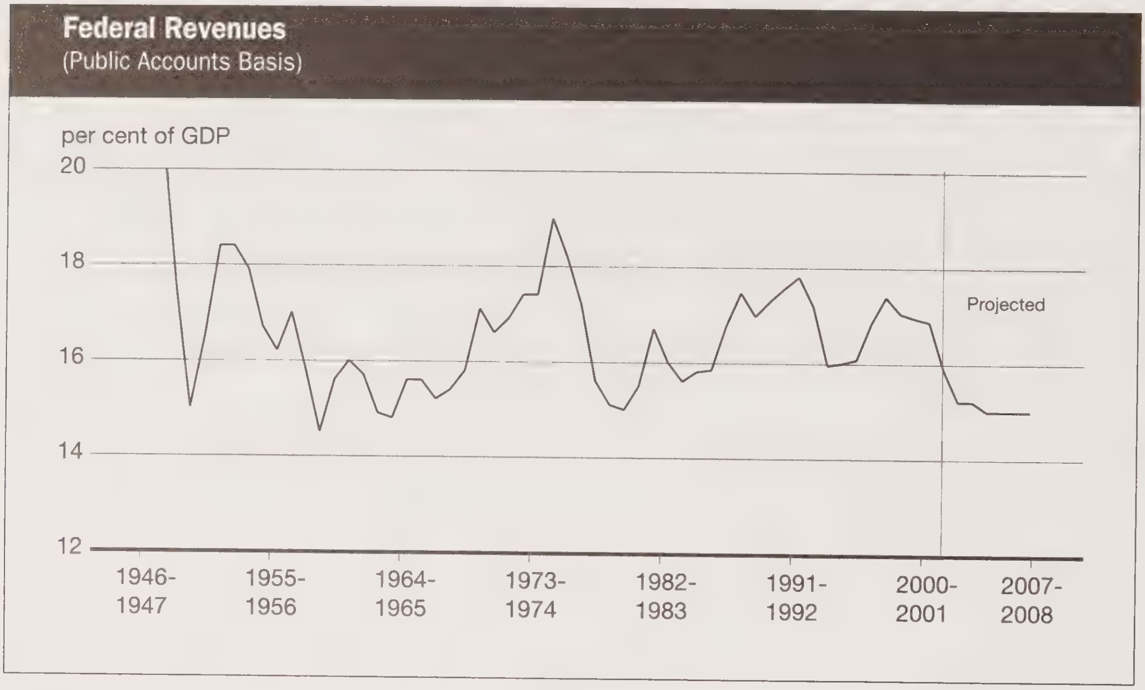
Note: Numbers may not add due to rounding.
[1] Actual results.

- Based on the economic-planning assumptions described in Annex 1, budgetary revenues are expected to remain virtually unchanged in 2002-03 from 2001-02. This reflects the lagged impact of the economic weakness in 2001 on tax collections, especially personal and corporate income tax revenues.

- As reported in the August 2002 *Fiscal Monitor*, both personal and corporate income tax revenues are down significantly in the first five months of 2002-03 from the same period of 2001-02. This deterioration primarily reflects the decline in the stock market in 2001, which resulted in higher personal income tax refunds and lower settlement payments in April and May 2002. In addition, corporate income tax refunds are higher, as corporations are applying losses experienced in 2001 to taxes paid in previous years. These largely one-time adjustments depressed revenues in the first half of 2002-03. Increases in budgetary revenues are expected over the balance of the year, thereby offsetting the declines recorded in the first half.

- Thereafter the profile of revenues reflects the impact of sustained economic growth and the ongoing impact of the $100-billion Five-Year Tax Reduction Plan. Beyond 2004-05 revenue growth is somewhat stronger, as the tax reduction plan is fully implemented.

Revenue ratio permanently lowered due to tax cuts



- A more revealing picture of movements in tax revenue can be obtained by examining the "revenue ratio" – total federal revenues in relation to the total income in the economy (or GDP).

- This ratio primarily reflects the impact of policy decisions and economic developments. The large decline in the ratio following World War II was largely attributable to the lowering of taxes and the ending of special arrangements with the provinces to finance the war effort. The reform of the income tax system and the transfer of tax points to the provinces were largely responsible for the reduction in the ratio from 1972-73 to 1977-78. Economic developments accounted for most of the remaining fluctuations in this ratio. It declines during economic downturns and tends to increase during recoveries, reflecting the progressive nature of the tax system and the cyclical nature of corporate profits.

- Looking forward, the revenue ratio is projected to be significantly lower than in the past. This is attributable to the ongoing impact of the Five-Year Tax Reduction Plan, which has lowered the ratio on a permanent basis.

- The revenue ratio is projected to decline from 16.9 per cent in 2000-01 to 15.1 per cent by 2004-05 – a level not seen since the early 1960s – and to remain relatively stable thereafter.

Average private sector projections of total program spending

Table 3.5
Program Spending – October 2002 Update: Private Sector Average

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	(millions of dollars)						
Major transfers to persons							
Elderly benefits	25,365	26,559	27,639	28,618	29,629	30,736	32,012
Employment insurance benefits	13,748	15,356	15,284	15,883	16,685	17,387	17,905
Total	39,113	41,915	42,923	44,501	46,315	48,123	49,916
Major transfers to other levels of government							
Canada Health and Social Transfer	17,300	18,600	19,300	20,400	21,000	21,600	22,200
Fiscal arrangements	12,010	12,704	13,420	14,133	14,817	15,537	16,279
Alternative Payments for Standing Programs	-2,662	-2,544	-2,697	-2,752	-2,779	-2,876	-2,977
Total	26,648	28,760	30,023	31,781	33,038	34,261	35,502
Direct program spending	60,944	63,662	67,724	70,365	73,074	75,623	78,158
Total program spending	126,705	134,337	140,670	146,647	152,427	158,007	163,576
Per cent of GDP							
Major transfers to persons							
Elderly benefits	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Employment insurance benefits	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Total	3.6	3.7	3.6	3.5	3.5	3.4	3.4
Major transfers to other levels of government							
Canada Health and Social Transfer	1.6	1.6	1.6	1.6	1.6	1.5	1.5
Fiscal arrangements	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Alternative Payments for Standing Programs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Total	2.4	2.5	2.5	2.5	2.5	2.4	2.4
Direct program spending	5.6	5.6	5.6	5.5	5.5	5.4	5.3
Total program spending	11.6	11.8	11.6	11.5	11.4	11.3	11.1

Note: Numbers may not add due to rounding.

[1] Actual results.

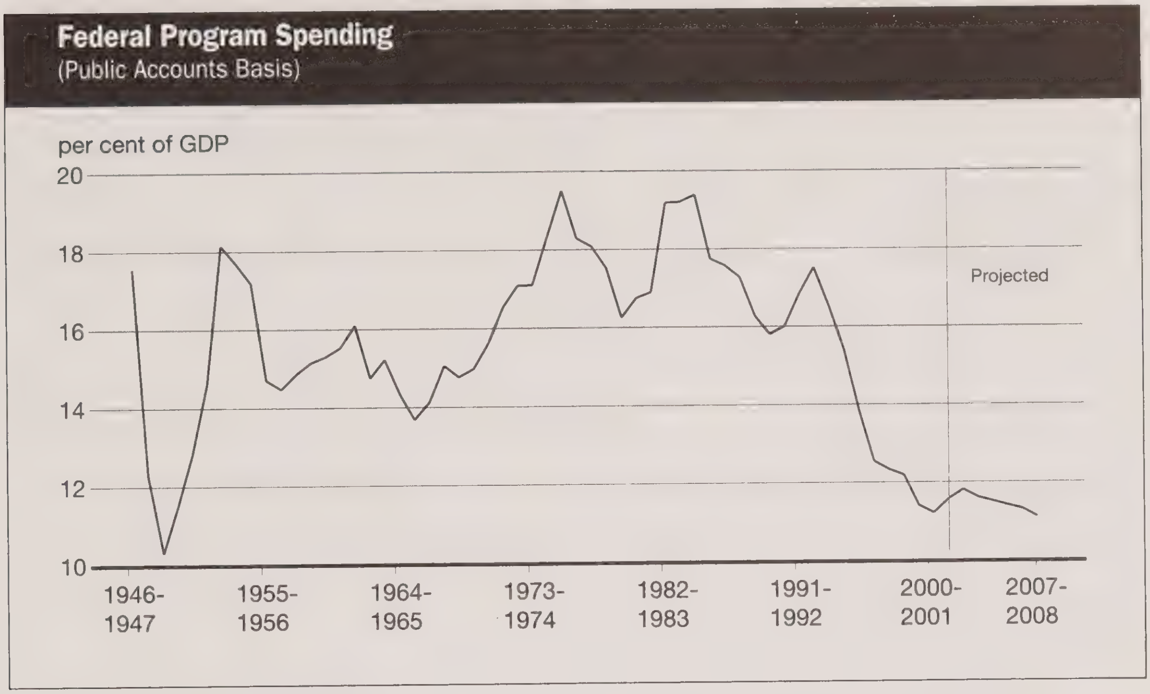
- The projections of program spending in Table 3.5 include the impact of the Agreements on Health Renewal and Early Childhood Development reached in September 2000, the February 2000 budget and September 2000 enhancements to employment insurance benefits, and initiatives announced in the December 2001 budget. They also include initiatives announced since the 2001 budget, which are shown in Table 3.2.

- Program spending is divided into three major components: major transfers to persons, major transfers to other levels of government and direct program spending.

- Based on the average of the projections provided by three forecasting firms, total program spending is estimated to increase from $126.7 billion in 2001-02 to $134.3 billion in 2002-03, representing an increase of 6.0 per cent. This increase of $7.6 billion is spread among all three major components of program spending.
  - Major transfers to persons, consisting of elderly and employment insurance benefits, are expected to increase by $2.8 billion, or 7.2 per cent. The growth in elderly benefits is largely determined by the growth in the elderly population and average benefits, which are fully indexed to quarterly changes in consumer prices. The growth in employment insurance benefits reflects the lagged impact of the economic slowdown in 2001 as well as the effect of program enhancements. The latter includes the extension of and related changes to parental benefits and modifications to the intensity and clawback provisions.
  - Major transfers to other levels of government are expected to increase by $2.1 billion, or 7.9 per cent. Under the Agreements on Health Renewal and Early Childhood Development reached by first ministers in September 2000, cash under the Canada Health and Social Transfer (CHST) increases by $1.3 billion in 2002-03. An increase of $0.7 billion is expected in fiscal arrangements, primarily for equalization entitlements, which for planning purposes are assumed to grow in line with nominal GDP.
  - Direct program spending is expected to increase by $2.7 billion, or 4.5 per cent, reflecting the impact of the security measures announced in the December 2001 budget as well as new spending decisions announced since the budget.

- Thereafter, on a status quo policy basis, the rate of growth in program spending is projected to slow as the measures announced in previous budgets are fully reflected in the spending projections and the impact of an improving labour market restrains the growth in employment insurance benefits. For planning purposes, a continuation of the increase in CHST cash transfers in 2005-06 is assumed for both 2006-07 and 2007-08.

Program spending as a share of GDP continues to decline



- Program spending as a per cent of GDP, on a status quo basis, is expected to increase slightly in 2002-03, reflecting the impact of higher cash transfers to the provinces and increased employment insurance benefits.
- Beyond 2002-03, on a status quo basis, the ratio declines as the growth in the economy exceeds that in program spending.

Sensitivity of the fiscal outlook to economic shocks

Table 3.6
Estimated Change in Fiscal Position

	Year 1	Year 2
	(billions of dollars)	
1-per-cent decrease in real GDP growth		
Revenue impact	-1.8	-1.9
Expenditure impact	0.5	0.7
Deterioration in fiscal balance	-2.4	-2.6
1-per-cent decline in GDP inflation		
Revenue impact	-1.9	-1.8
Expenditure impact	-0.5	-0.5
Deterioration in fiscal balance	-1.4	-1.3
100-basis-point decrease in interest rates		
Revenue impact	-0.4	-0.5
Expenditure impact	-1.1	-1.9
Improvement in fiscal balance	0.8	1.4

Note: Numbers may not add due to rounding.

- The fiscal projections are extremely sensitive to changes in economic assumptions – particularly to changes in real economic (GDP) growth, inflation and interest rates.

- A decrease in the growth of real GDP (through equal reductions in employment and productivity) would lead to lower federal government revenues through a contraction in various tax bases and an increase in spending, primarily due to higher employment insurance benefits. Using standard sensitivity analysis, a 1-per-cent decrease in real GDP for one year would lower the budgetary balance by $2.4 billion in the first year and by $2.6 billion in the second year.

- A 1-per-cent reduction in the growth of nominal GDP resulting solely from a 1-per-cent decline in the rate of GDP inflation would lower the budgetary balance by $1.4 billion in the first year and $1.3 billion in year two. Most of the impact would be on budgetary revenues, as wages and profits would be lower, as well as the price of goods and services subject to sales and excise taxes. The impact on expenditures would be largely reflected in programs that are indexed to inflation, such as elderly benefit payments.

- A sustained 100-basis-point decline in all interest rates would improve the budgetary balance by $0.8 billion in the first year, rising to $1.4 billion in year two. This improvement comes solely from the reduction in public debt charges, which reduces overall budgetary expenditures. Expenditures would fall by $1.1 billion in the first year and $1.9 billion in year two, as longer-term debt matures and is refinanced at the lower rates. Moderating this impact are somewhat lower interest earnings on the Government's interest-bearing assets, which are recorded as part of non-tax revenues.

Annex 4

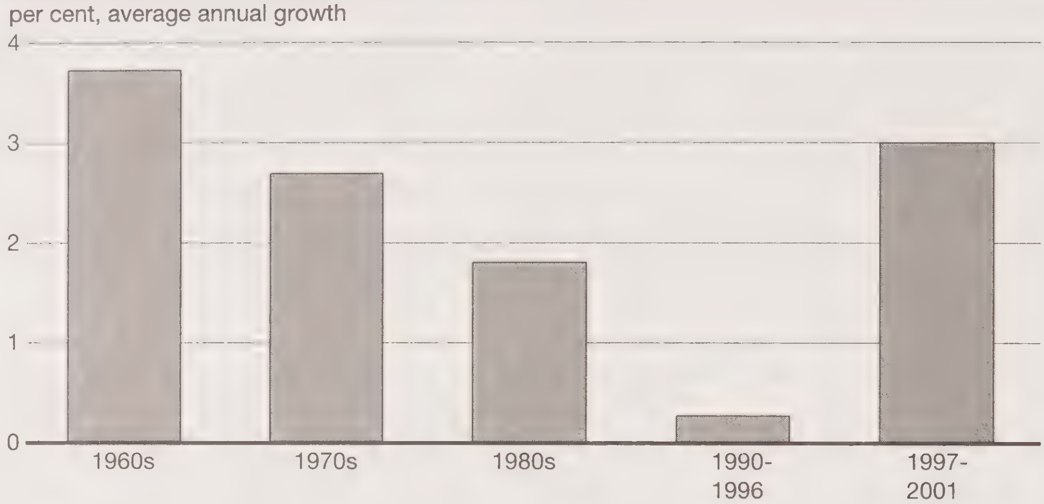
Improving Canadian Living Standards

Highlights

- *The central objective of economic and social policy is to enhance the well-being of people through higher living standards and a higher quality of life.*
- *Growth in Canada's living standards has increased substantially over the past five years, more than in any other Group of Seven (G-7) country.*
- *Our superior performance since 1997 has narrowed the gap in living standards between Canada and the United States, but a sizeable gap remains.*
- *Both stronger productivity growth and labour market progress have been responsible for narrowing the Canada-US living standards gap since 1997. Looking ahead, population aging will limit the scope for further large contributions from employment and we will need to look predominantly to stronger productivity growth to raise living standards and help close the gap with the United States.*
- *Economic factors such as fiscal and monetary stability, competitive taxes, investment in learning, new technologies and research and innovation are all key to helping Canada improve its productivity performance. Equally important is building a stronger society to give Canadians a higher quality of life and the skills and confidence to participate in the new economy.*
- *Only through integrated and complementary economic and social progress will Canada achieve its goal of strong and sustainable living standards growth along with a better quality of life for all Canadians in the future.*

Canadian living standards growth slowed in the 1980s and early 1990s, but has rebounded since 1997

Growth in Canadian Real GDP Per Capita



Source: Statistics Canada.

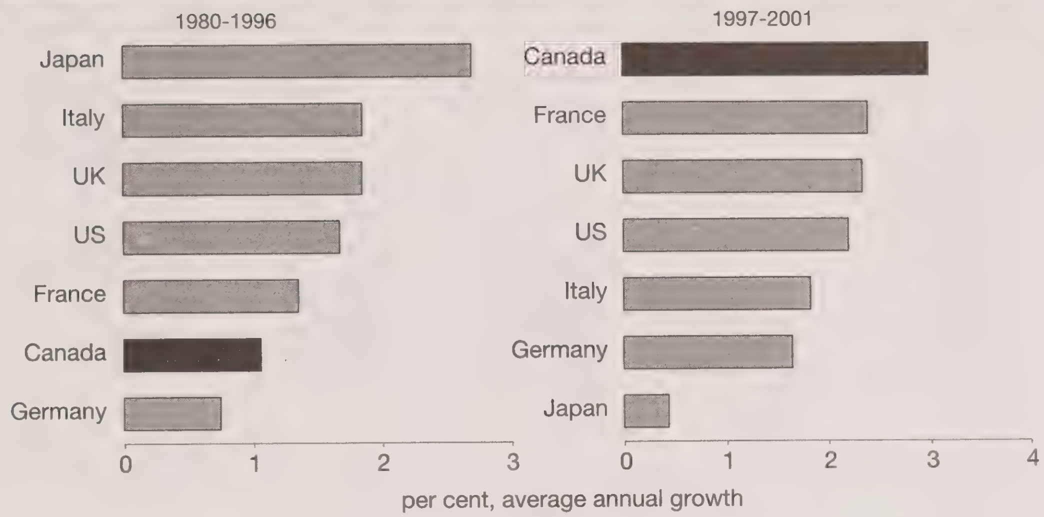
- The most commonly used measure of living standards is real (inflation-adjusted) GDP per capita. GDP is a measure of all goods and services produced in the country in a year. Equivalently, GDP measures the amount of income generated in Canada during a year, including wages and salaries, business profits and earnings from self-employment.

- In the 1960s and 1970s real GDP per capita grew rapidly in Canada, averaging over 3 per cent per year. However, this was followed by slow growth in the 1980s and almost no growth in the first half of the 1990s.

- Since 1997, with governments balancing their budgets, Canada's living standards performance has turned around substantially. Real GDP per capita has grown by an average rate of 3 per cent per year, similar to that achieved over the 1960s and 1970s.

Canada's performance relative to other G-7 countries has improved significantly

Growth in Real GDP Per Capita in G-7 Countries

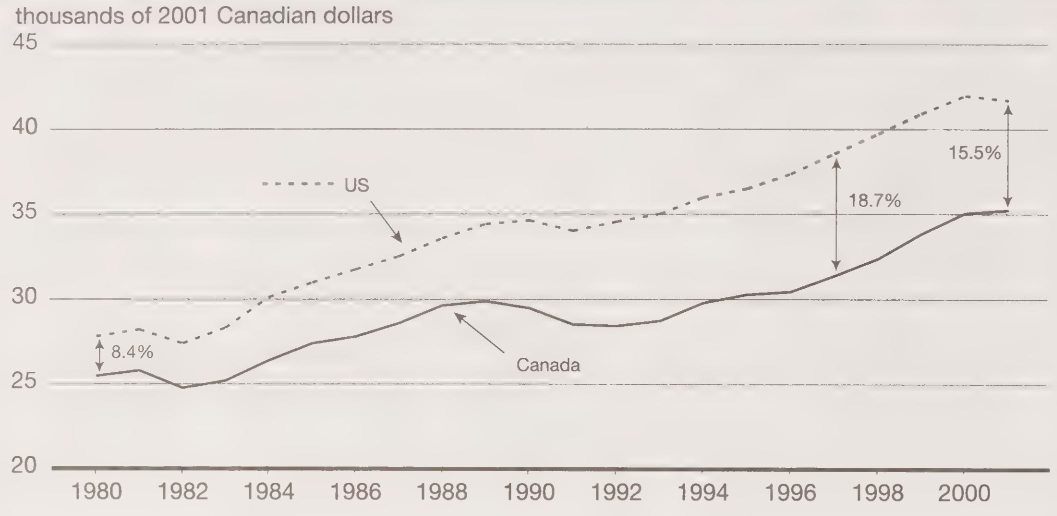


Source: *OECD Economic Outlook No. 71* (June 2002).

- Over the 1980-1996 period, a period when Canada was experiencing sustained and large fiscal deficits, it ranked second last among the G-7 countries and 22nd among all Organisation for Economic Co-operation and Development (OECD) countries in terms of real GDP per capita growth.
- The 1997-2001 period marked a major turnaround, with real GDP per capita growing faster in Canada than in any other G-7 country. Our ranking among OECD countries improved from 22nd to 9th place over this period.

The living standards gap with the United States has narrowed over the last five years but remains sizeable

Real GDP Per Capita: Canada and the US



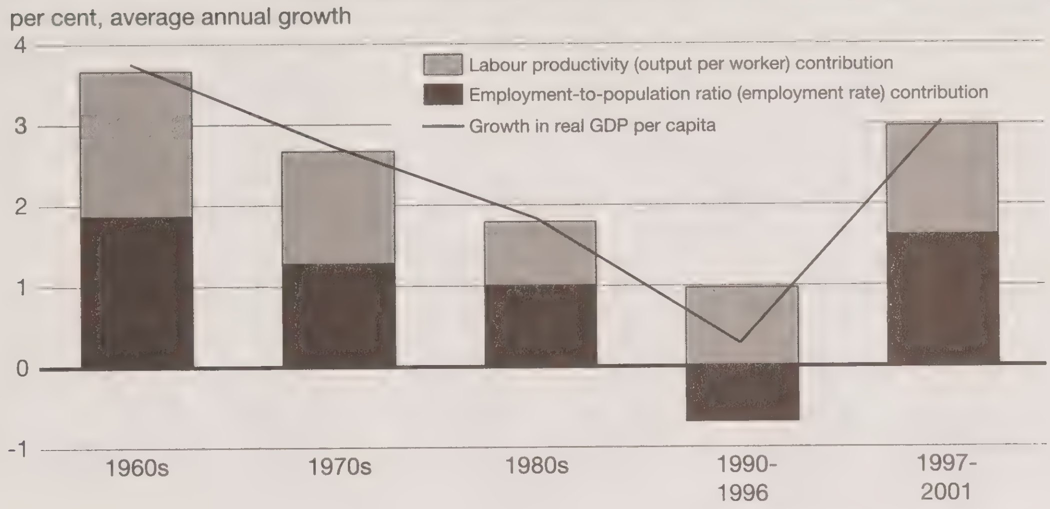
Note: Based on Statistics Canada's bilateral purchasing power parity of 0.85 US$/C$ for 2001.

Source: Department of Finance calculations based on data from Statistics Canada and the US Bureau of Economic Analysis.

- The living standards gap between Canada and the United States, which stood at 8.4 per cent in 1980, widened through the 1980s and the first half of the 1990s, peaking at almost 19 per cent in 1997.
- With Canada's strong economic performance over the past five years, the gap has started to narrow to roughly 15 per cent; however, it remains sizeable.
- Clearly, one of Canada's key challenges in the future is to further narrow and eventually close our standard of living gap with the United States.

Strong employment growth and faster labour productivity growth have both contributed to the recent living standards growth rebound

Contribution to Real GDP Per Capita Growth

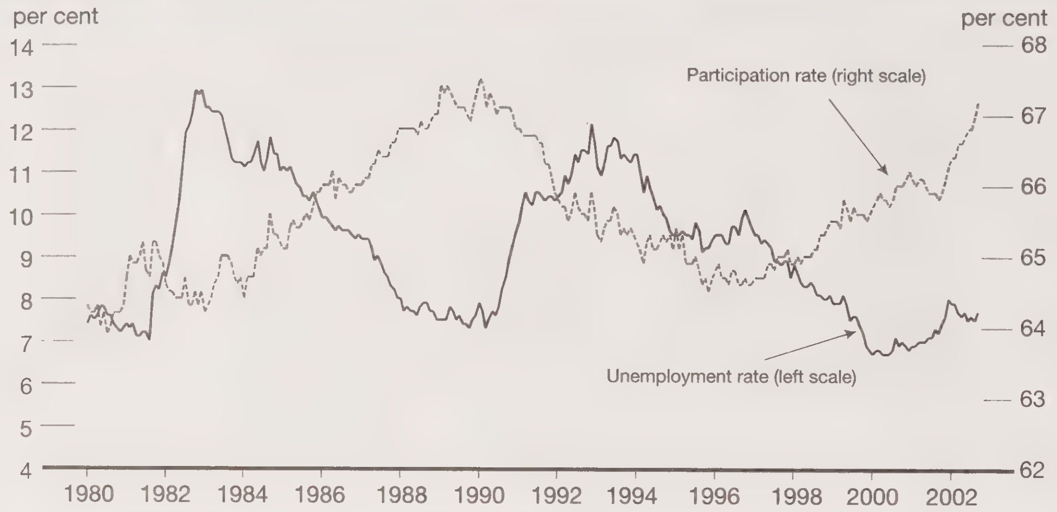


Source: Department of Finance calculations based on Statistics Canada data.

- Living standards can be raised by increasing the share of the population that is working (the employment rate) or by growth in productivity (the average value of goods and services produced by each person working).
- In the 1960s and 1970s living standards growth was generated by both strong labour productivity growth and a rising employment rate, as the baby boom generation entered the labour market and the participation rate of women increased.
- By the 1980s the growth in both productivity and the employment rate had slowed significantly, and in the early 1990s the employment rate fell. As a result, the growth in our standard of living virtually stalled between 1990 and 1996, with increases averaging only 0.3 per cent annually.
- Real GDP per capita growth has rebounded significantly since 1997, generated by both a sizeable increase in the employment rate and a strong improvement in labour productivity growth.

Labour market progress has been responsible for narrowing the Canada-US living standards gap over the past five years ...

Unemployment and Participation Rates

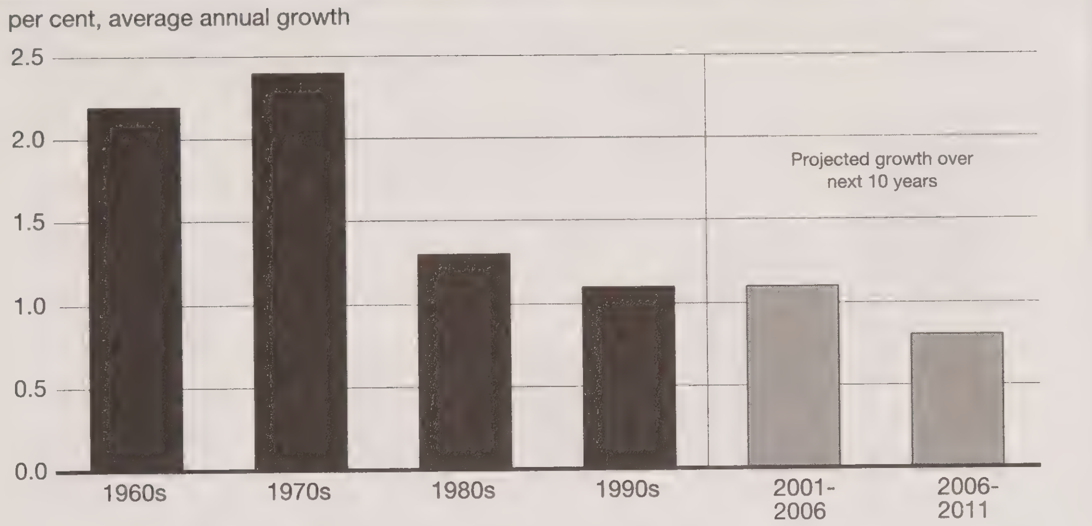


Source: Statistics Canada.

- The rebound in the employment rate since 1997 reflects a rise in the proportion of the population in the labour force (the participation rate) and a decline in Canada's unemployment rate.
  - The participation rate increased by 1.3 percentage points from 1996 to 2001, after declining through the early 1990s. It has continued to rise in 2002 and is now above the US rate for the first time since 1991.
  - Canada's average annual unemployment rate declined by 2.4 percentage points from 1996 to 2001, from 9.6 per cent to 7.2 per cent. In contrast, the US unemployment rate declined by only 0.6 percentage points over the same period.
  - In 2001, 1.6 million more Canadians were working than five years earlier. Canada's job creation record over this period was the best among the G-7 countries, including the United States.

... but population aging will limit the scope for further large increases in the employment rate

Growth in Working-Age Population (Aged 15-64)

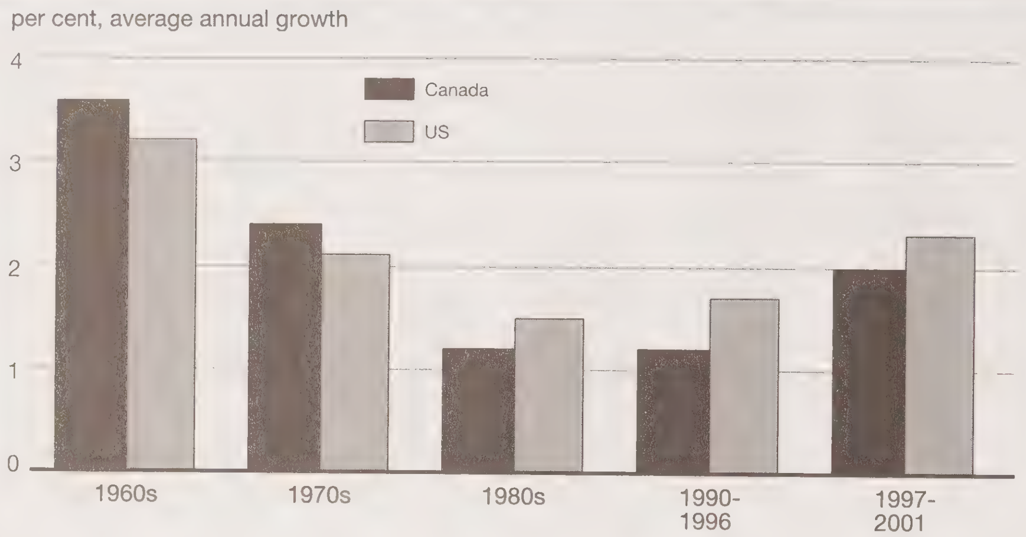


Source: Department of Finance calculations based on Statistics Canada data.

- Looking ahead, there will be less potential for Canada to make further gains in living standards growth through increases in the employment rate.
  - The participation rate is near its historical peak.
  - The unemployment rate has declined and while it could certainly fall further, declines of the magnitude seen over the past decade are unlikely. Canada has narrowed its unemployment rate gap with the US from almost 5 percentage points in late 1996 to 2.1 percentage points in September 2002.
  - Growth in the working-age population (aged 15-64), which was a key factor behind the growth in overall employment during the 1960s and 1970s, has since slowed considerably. Demographic projections show that working-age population growth will slow even further as the baby boom generation reaches retirement age.
- As a result, we cannot count on a rising employment rate as a key source of living standards growth in the future; improvements in living standards will have to come predominantly from productivity improvements.

Closing the Canada-US living standards gap will require faster productivity growth

Business Sector Labour Productivity[1] Growth in Canada and the US



[1] Measured as output per hour worked.

Source: Department of Finance calculations based on data from Statistics Canada and the US Bureau of Economic Analysis.

- In the 1960s and 1970s Canadian business sector labour productivity growth outpaced that of the United States. However, in the 1980s it lagged US growth, with the gap widening further in the first half of the 1990s.

- Since then Canadian productivity growth rates have increased significantly, almost catching up with those in the United States even as US productivity growth surged ahead. Average hourly business sector labour productivity growth in Canada rose from 1.2 per cent between 1990 and 1996 to 2.0 per cent over the 1997-2001 period, whereas in the US it rose from 1.7 per cent to 2.3 per cent. However, a sizeable gap in the levels of productivity performance between the two countries remains.

- Looking forward, given the more limited scope for the employment rate to increase, labour productivity growth in Canada will need to exceed that of the United States if we are to close the living standards gap with the US.

Economic factors that influence productivity

Key Economic Factors

✓ Fiscal and monetary stability
✓ Research and innovation
✓ Investment in machinery and equipment
✓ Adequate access to financing for firms
✓ Openness to trade and foreign investment
✓ Favourable business climate

- Canadian businesses must be the catalysts for raising productivity growth. However, there are a number of areas in which government policy can play a role – to help create the right economic conditions to support private sector productivity growth.

- A stable macroeconomic environment with balanced budgets and low inflation brings lower interest rates and boosts confidence, thereby encouraging investment, which is an important source of productivity growth.

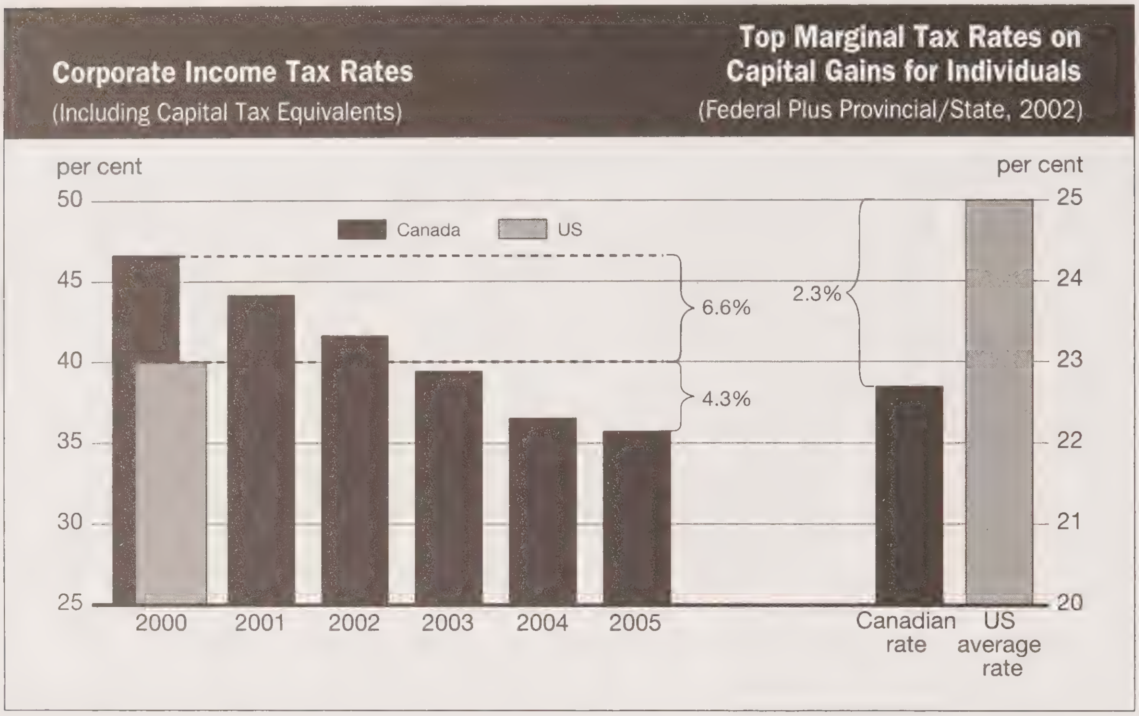
- Government support for research and innovation helps provide the funding needed for firms and researchers to create new products, processes and services that enhance their productivity. Access to capital is also critical to fostering innovative companies – for new businesses as well as those at various stages of development.

- Openness to trade and foreign investment allows goods and services to move freely across countries and allows Canadians to benefit from technological developments abroad.

- A favourable business climate includes factors such as supportive, more efficient regulation and competitive taxes. Lower personal taxes improve incentives to work, save and invest; lower corporate and capital gains taxes encourage entrepreneurship and innovation and stimulate investment.

- Governments have been making a significant number of contributions in Canada on these fronts over the past few years.

Canada's recent $100-billion tax cut created tax advantages for firms and entrepreneurs to grow



Source: Department of Finance.

- For example, in the 2000 budget and October 2000 *Economic Statement and Budget Update*, the Government introduced a five-year, $100-billion plan of tax reductions – the largest tax cuts in Canadian history. The tax reduction plan announced significant personal income tax reductions and created tax advantages for firms and entrepreneurs to grow:
  - By 2004-05, federal personal income taxes will be 21 per cent less on average and 27 per cent less for families with children.
  - Combined with tax reductions by the provinces, the average general corporate tax rate in Canada will fall below that of the US in 2003, from almost 7 percentage points above the US rate in 2000. By 2005 firms in Canada will have a 4.3-per-cent corporate income tax rate advantage over their US counterparts (including capital taxes).
  - Canada's top marginal capital gains tax rate is now lower than the typical top US rate.
  - As well, the employment insurance premium rate has been reduced by 28 per cent, falling from $3.07 in 1994 to $2.20 in 2002.
- These tax reductions will enhance incentives to work, save and invest, help create jobs and improve our productivity performance.

Social factors can support a productive economy

Key Social Factors

✓ Helping children and families

✓ Medicare/health

✓ Social policies geared to learning
  - Early childhood development, kindergarten to grade 12, post-secondary education, on-the-job training

✓ Healthy communities

- Progress on the economic front is key to raising productivity and living standards, but equally important is improving our social capital by investing in people and the infrastructure that supports them. Canada's education and health care systems, for example, provide Canadians with the skills and the sense of security that allow them to participate in the economy with confidence. Equally, they provide Canadian businesses with a competitive advantage in the global marketplace.

- As an example of combining good social policy with good economic policy, the National Child Benefit supplement, the federal contribution to the National Child Benefit initiative (a joint federal-provincial-territorial initiative) and a component of the Canada Child Tax Benefit (CCTB), has allowed provinces to reinvest social assistance savings to improve incentives to work for low-income families with children. Total federal government support to help low- and middle-income Canadian families through the CCTB will have increased from $5.4 billion in 1997-98 to $8.7 billion by 2004-05, an increase of $3.3 billion or 61 per cent.

- Policies geared toward learning help bring more people into the workforce and better equip them to work in higher-wage, higher-skill jobs. Implementing those policies requires investments at all stages of life: from early childhood development through to post-secondary education, to graduate schools that can attract the very best from around the world, and on-the-job training and mentoring programs to help Canadians become lifelong learners.

- As well, healthy communities are key to attracting and retaining talent and investment. As stated in the 2002 Speech from the Throne, competitive cities "require not only strong industries, but also safe neighbourhoods; not only a dynamic labour force, but access to a rich and diverse cultural life."

- The goals of attaining a stronger, more productive economy and building a stronger society are mutually reinforcing. Only through progress on both fronts will Canada be able to achieve its ultimate goal of rising living standards and a better quality of life for all Canadians in the years to come.

Annex 5

Implementation of Full Accrual Accounting in the Federal Government's Financial Statements

Highlights

- *Since the mid-1980s the Government has made a number of accounting policy changes to better reflect its overall financial position. These have included the recognition of most liabilities (such as public sector employee pension liabilities), the accrual of non-tax revenues and the consolidation of a number of specified purpose accounts. As a result of these changes, the Government's financial statements are currently on a modified accrual basis of accounting.*

- *In the February 1995 budget the Government announced its intention to adopt full accrual accounting as one of the initiatives undertaken as part of its Program Review exercise to increase efficiency through better management. The adoption of full accrual accounting has been endorsed by the Auditor General of Canada as being superior to the Government's current accounting practices.*

- *It is the Government's intention to implement full accrual accounting in the upcoming budget provided it is able to finalize and verify the accrual accounting amounts by late fall. The Office of the Auditor General of Canada has been assisting in the verification of these amounts. The Government's objective is to have sufficient assurance as to the reliability of the accrual accounting amounts before proceeding with formal implementation in the upcoming budget.*

- *The Government's fiscal anchor remains the budgetary balance. With this shift in accounting treatment in the upcoming budget, it would be calculated on a full accrual basis of accounting rather than on the current modified accrual basis.*

- *This annex explains what accrual accounting is, sets out the rationale for moving to full accrual accounting and indicates the potential impacts on the Government's financial statements. Once the full accrual numbers are finalized, a more comprehensive analysis of the difference between the current modified accrual and full accrual results will be published.*

What Is Accrual Accounting?

- An accrual accounting framework provides a more complete picture of the overall size of government, enhances accountability to Parliament and improves internal decision making and cost-effectiveness.
  - Accrual accounting recognizes transactions and other events when they occur and not when cash is received or paid. Expenses are recorded in the period when the goods and services are consumed (used). This implies that multi-year benefits associated with capital assets are matched to the time that they are expected to be used. Revenues are recorded in the period to which they pertain rather than when they are received.
- Under the Government's present accounting practices (modified accrual):
  - Expenditures, with the exception of capital, some retirement and post-employment benefits, and environmental liabilities, are on an accrual basis of accounting. This means that payables and liabilities are recognized when they are incurred and not when the cash payment is made.
  - Capital assets and consumable inventories are fully expensed, or accounted for, in the year in which they are acquired. For example, when the Canadian Coast Guard buys a new vessel, the costs of that vessel are recognized when the Coast Guard takes ownership of it. The full cost, therefore, is reflected in the Government's financial statements at that time.
  - Tax revenues are on a cash basis. This means they are included when they are received. Given collection lags, administrative changes, etc., this results in revenues being received after the economic event giving rise to these revenues has taken place. As a result, the fiscal outcome in the current fiscal year reflects not only what happens in the current fiscal year but also what happened in the previous year.
  - While the financial activities of enterprise Crown corporations have been reflected in the Government's annual balance since 1992-93, their net assets and liabilities, outstanding at that time, have not been included.
- Under full accrual accounting:
  - Capital assets will be recognized in the Government's financial statements. Capital expenditures will be amortized over their economic life rather than being fully expensed in the year(s) in which they are acquired. For example, the cost of a vessel purchased by the Canadian Coast Guard will now be spread out over the estimated useful life of that vessel rather than fully expensed in the year it is purchased. This will more accurately reflect the cost of using these assets and relate them to the services provided and results achieved in these periods.
  - The recognition of retirement and post-employment benefits will be expanded. Benefits, such as health care and dental plan liabilities, workers' compensation and veterans' disability pensions, will be included in the Government's financial statements.

- Tax revenues will be recognized in the period to which they pertain and not when they are received. There are significant collection lags between the economic event giving rise to tax revenues and when those revenues are received. For example, taxpayers are required to file their personal income tax returns for the preceding taxation year no later than the end of April of the current taxation year. This results in a large influx of personal income tax revenues in late April and early May pertaining to tax liabilities incurred in the previous taxation year. The Government sends out refunds during the April to June period for overpayments of taxes made in previous years. The annual flow of revenues can also be affected by remittance procedure changes, delays due to labour disputes, system processing problems, etc. Under accrual accounting, revenues will be recorded in the year to which they relate, thereby eliminating the distortions between cash collections/disbursements and economic developments. These changes would present a better picture of the Government's overall financial position.
- Since 1992-93 the Government has been reporting its investments in enterprise Crown corporations on a cost basis, with an allowance for annual profits and losses. The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants recommends that governments account for enterprise Crown corporations using the modified equity approach, whereby annual profits and losses and the Government's investments in these corporations are reflected fully in the Government's financial statements. Although this change will have no impact on the annual results, it will increase the Government's recorded financial assets as a result of not having recognized these profits and losses prior to 1992-93.
- Currently the Government does not recognize its environmental liabilities in the financial statements and Aboriginal liabilities are not fully recognized. In moving to full accrual, the Government will change its accounting policies with respect to these liabilities and fully incorporate them in the financial statements.

What Is the Rationale for Implementing Full Accrual Accounting?

- Accrual accounting helps users, including legislators, managers and budget planners, appreciate and better understand the full scope of government activities.
  - The financial results are more indicative of economic developments and government actions undertaken during the course of the fiscal year.
  - A more complete picture enables Canadians and legislators to hold the Government more fully accountable for the stewardship of its assets, the costs of its programs, the results achieved, and its ability to meet its short- and long-term financial commitments.
  - The accrual and resulting amortization of capital assets requires the Government to consider the long-term benefits and consequences of purchasing capital assets. Complete records of assets will now be required. This additional information will require that departments consider maintenance needs, appropriate replacement policies, and the identification and disposal of excess assets, as well as risks such as loss due to theft or damage.
  - Recognition of liabilities (environmental, Aboriginal, retirement and post-employment benefits) will require the development of plans for managing these liabilities. This will place more responsibility on departments to ensure that these liabilities are effectively managed. It will also ensure that costs are recorded when incurred.
  - The inclusion of all costs of operations will result in a more complete picture of the cost-effectiveness of programs.

- The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants recommends that senior levels of government adopt full accrual accounting in their financial statements.

- Many provinces have adopted full accrual accounting as have a number of foreign governments, including the United States, Australia and New Zealand. The United Kingdom has indicated its intention to adopt full accrual accounting.

- The Auditor General of Canada fully supports the use of full accrual accounting and urges the Government to implement it as soon as possible. In her "Observations" on the Government's 2001-02 financial statements, the Auditor General states: "I remain convinced that accrual accounting is superior to the Government's current accounting policies. It provides a more complete measure of the overall size of the Government, which should enhance accountability to Parliament; it eliminates the distortion of reported financial results caused by altering the timing of cash receipts and disbursements; and it is an essential component of management reform initiatives underway in the Government. I encourage the Government to resolve concerns which are causing delays in the full introduction of accrual accounting and implement it for the 2002-03 financial statements."[1]

- The Government is still reviewing and consulting with stakeholders as to whether the Main Estimates and appropriations to Parliament should be put on full accrual as well. A working group has been established to examine these issues.

[1] *Public Accounts of Canada* (2002), Volume 1.

What Does It Imply?

- The Government's financial statements summarize both the annual flow of revenues and expenditures (the annual budgetary balance) and the stock of assets and liabilities. Adopting full accrual accounting will affect both statements.

Impact on Annual Budgetary Balance

- The Government's fiscal anchor – the budgetary balance – remains the same except that it will now be presented on a full accrual basis of accounting rather than on the current modified accrual basis. As such, it will be more reflective of current economic events and liabilities.

- The most significant changes will be:
  - Annual expenditures will no longer include the amounts spent during the year on capital (i.e. buildings and equipment). Instead, they will be expensed as they are used. That is, their cost will be amortized over their economic life. This will tend to slightly improve the annual budgetary balance, other things being equal, as the amortization adjustment for capital is somewhat less than current expenditures on capital.
  - The annual budgetary balance will now include a larger group of liabilities than before. Annual changes in these liabilities will have a direct effect on the budgetary balance.
  - Although the annual budgetary balance will include the same revenue sources, tax revenues recorded in each year will now be more reflective of economic developments during that year. Under the cash basis of accounting, there are significant collection lags, whereby the revenues reported in the current period can be more reflective of what happened in the previous fiscal year than in the current one. For example, given the different pattern of economic developments in 2000 and 2001, it is expected that the accrual of tax revenue will increase the budgetary surplus in 2000-01 but reduce it in 2001-02.

Impact on Net Debt and Accumulated Deficit (Statement of Assets and Liabilities)

- Under the modified accrual basis of accounting, the Government's net debt and accumulated deficit (the accumulation of all past deficits and surpluses) were measured the same way. Under full accrual accounting, net debt and the accumulated deficit will no longer be defined in the same way, as the accumulated deficit will now include non-financial assets.

- Net debt under full accrual will still represent the difference between gross liabilities and financial assets.
  - It will be more comprehensive as gross liabilities will include an expanded list of liabilities, which will increase total liabilities.
  - Financial assets will now include tax receivables.
  - It is expected that the impact of these changes will be largely offsetting. Net debt under full accrual could be slightly higher or lower than under the current modified accrual basis.
  - Net debt is an important financial indicator as it provides information regarding the extent to which the expenditures of the Government in the fiscal year have been met by revenues recognized in that fiscal year. Net debt will continue to be shown on the Government's financial statements.
- The accumulated deficit will now include non-financial assets.
  - It will be defined as the Government's net debt plus its non-financial assets. Accordingly, it will be smaller than net debt.
- It is still too early to provide quantitative estimates of the impact of these changes, as the Government is in the process of finalizing the required accrual estimates.

Impact of Accrual Accounting on Net Debt and Accumulated Deficit

		(billions of dollars)
Net debt at March 31, 2002		536.5
Impact of accrual accounting on net debt		
Impact on liabilities		
Aboriginal claims		plus
Environmental liabilities		plus
Post-employment benefits		plus
Retirement benefits		plus
Impact on financial assets		
Net tax receivables		plus
Unrecorded equity of enterprise Crown corporations		plus
Net impact on net debt	plus/minus	536.5
Non-financial assets		
Tangible capital assets		plus
Prepaid expenses		plus
Inventories		plus
Accumulated deficit	less than	536.5

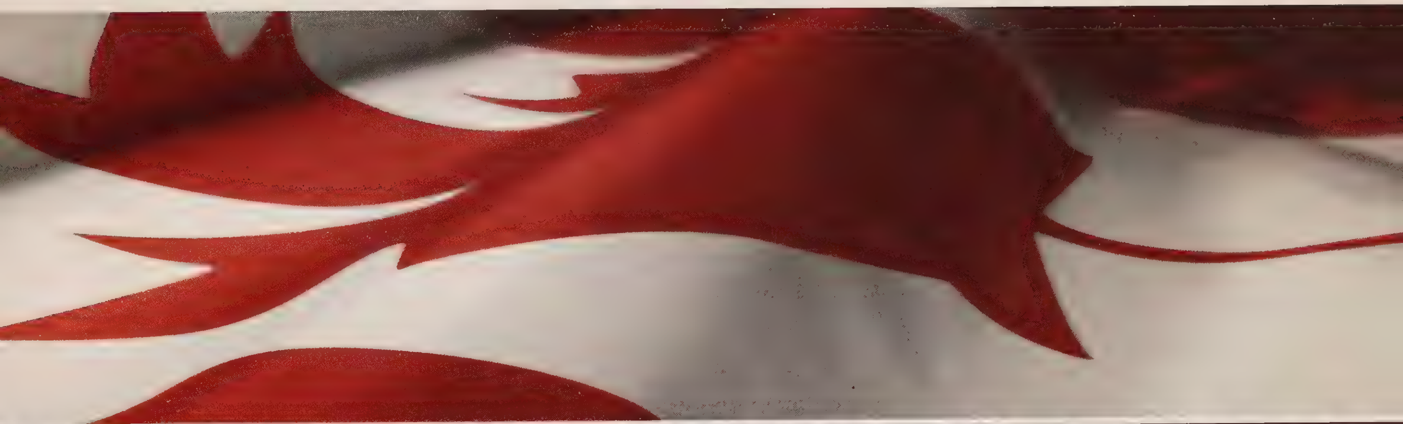
Next Steps

- It is the Government's intention to implement full accrual accounting in the upcoming budget provided it is able to finalize and verify the accrual accounting amounts by late fall. The Office of the Auditor General of Canada has been assisting in the verification of these amounts. The Government's objective is to have sufficient assurance as to the reliability of the accrual accounting amounts before proceeding with formal implementation in the upcoming budget.

- The timing of the implementation of full accrual accounting in the Government's financial statement and budget projections will depend on whether the accrual accounting adjustments meet the Government's required levels of audit assurance. Once that assurance has been received, the Government will present a paper comparing the 2001-02 financial results on both bases of accounting.

- Major accounting policy changes normally result in the restatement of previously published numbers. As a result, the current estimates for previous years will be restated to reflect the impact of these changes.

The Economic and Fiscal Update



November 3, 2003

Canada

The Economic and Fiscal Update

November 3, 2003

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Presentation

by the
Honourable John Manley, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

November 3, 2003
CHECK AGAINST DELIVERY

Introduction

Good morning. Thank you, Madam Chair and all members of the committee, for inviting me today to provide an update on Canada's economic and fiscal situation.

Let me start by saying that my appearance here before the committee today has special significance for me, and for my government. Tomorrow marks the 10th anniversary of our government. Ten years ago Canadians invested in us their hopes and aspirations for a better life—for themselves, for their communities and for Canada.

I probably don't have to remind you of the economic situation that we found when we assumed office. Ten years ago Canada was in the grip of a fiscal crisis. We faced an annual deficit of $38 billion and a crushing debt burden. Our federal debt equalled two-thirds of our nation's total annual economic output and was devouring more than 35 cents of every tax dollar, simply to pay interest. *The Wall Street Journal* called Canada "an honorary member of the Third World." And there was real concern that the International Monetary Fund (IMF) would have to step in to stabilize our financial situation.

That was then.

Ten years later, through the hard work and sacrifice of Canadians and a commitment to sound fiscal management, we have turned things around. We have put an end to 27 years of deficits and we have significantly reduced Canada's debt. The federal government has succeeded in keeping the annual inflation rate low—within the target band of 1 to 3 per cent. We have actively pursued freer and fairer trade. We have made smart investments in innovation and skills development and in key areas such as health and poverty reduction. We have renewed our commitment to improving accountability and transparency in the management of public resources. We have reduced taxes by $100 billion—the largest personal and corporate tax cuts in Canadian history.

Our ongoing review and reallocation exercise represents the beginning of a culture change in the public service. We will eliminate programs that don't work. We will adjust programs to new realities. We will align our programs to the changing priorities of Canadians. We will be prudent in our spending.

There are many reasons that our surplus last year was higher than projected. But one reason was that our program spending was lower than budgeted. That's a good sign and a portent for the future. Prudence, rigour, spending aligned with priorities are part of this government's commitment.

And the result, I think, is clear. Today Canada is among the economic and fiscal leaders of the Group of Seven (G-7). We have led the United States and the world's other largest economies in average growth over the last six years. Our debt-to-GDP (gross domestic product) ratio is now the second lowest in the G-7, a remarkable improvement from 10 years ago, when it was the second highest. And we are committed to keeping this ratio on a permanent downward track.

There is no doubt that we had to make some tough choices—and Canadians supported us in our resolve. In 10 short years Canadians have come together to create an economy that is entrepreneurial, resilient and capable of handling adversity at home and abroad—which brings me to the other reason that underscores the special significance of my appearance here today.

I am presenting this economic update to you in a year that has seen a dramatic series of unforeseen challenges affect Canadians and our economy. I think we all know the list: the fires and now floods in British Columbia, mad cow disease (bovine spongiform encephalopathy or BSE), the severe acute respiratory syndrome (SARS) outbreak, the August blackout in Ontario and Hurricane Juan on the East coast.

They all had an impact—on communities, on families and on our daily lives. As a government, we made the decision that we had to be there for Canadians who were put at risk—whether it is SARS or BSE or natural disasters. I am proud of that decision. But add to this weak global growth and the rapid rise in the value of the Canadian dollar, and I think it is fair to say that by any measure, 2003 has been a tough year for the Canadian economy.

And yet, our mettle tested, Canadians continue to be optimistic about the prospects for our economy and, I believe, confident about our future and the future of Canada.

And the world is taking notice. *The Economist* magazine recently described Canada as, and I quote, "rather cool." The magazine declares that our responsible fiscal management, combined with "a certain boldness" in our social policy, "points to an increasingly self-confident country." And I, for one, agree with this assessment.

Thanks to the determination of Canadians and the economic and fiscal measures taken over the past 10 years, our country has been able to withstand unforeseen shocks. And we are in a position today to take advantage of a global recovery that many economists believe is already underway.

Work Continues

Madam Chair, part of the story behind the relative strength of our economic position can be found in the recent efforts our government has made to help strengthen Canada's economic and fiscal framework.

As I have often said, sound fiscal management means continually reassessing government programs against the needs and priorities of Canadians. It means finding the most cost-effective ways of delivering high-quality services. And it means being accountable to Canadians by being transparent about how their tax dollars are managed and ultimately spent. As we set out in the February budget, we have taken significant steps to meet the demands of sound fiscal management and to improve public confidence.

First, as I mentioned earlier, we have begun the process of making reallocation of public resources an integral part of the way the federal government operates. To that end, the Treasury Board is leading a systematic and ongoing examination of all non-statutory program spending. Last month the President of the Treasury Board announced that this year the reallocation exercise has secured savings of $1 billion. And this is just the beginning. Canadians can expect to see even greater savings in the years to come, as the federal government continues to do a better job at moving resources from lower to higher priorities. This is not a one-time exercise, and we will get better at it. We will continue to strengthen our commitment to sound fiscal management by ensuring that reallocation remains a permanent feature of the way we manage the fiscal affairs of Canadians.

Second, we have taken important steps toward honouring our commitment to create a new rate-setting mechanism for employment insurance premiums. Consultations on this issue wrapped up this summer, and our goal now is to bring in legislation next year to establish a permanent rate-setting regime for 2005 and beyond.

Third, we are continuing our efforts to encourage reform in Canada's system of securities regulation to ensure that it promotes competitiveness, innovation and growth. Last March we established an independent panel of highly respected Canadians to review this issue. Their report is expected by the end of this month. This report will provide recommendations that all governments and stakeholders will be asked to consider to ensure that Canada's role in global capital markets remains strong.

In other areas of government business, we are pursuing our discussions with provincial and territorial governments on renewing the equalization and Territorial Formula Financing programs. As you know, these programs are vital to securing the well-being of millions of Canadians. Together with the provinces, we are working to improve the stability, predictability and integrity of equalization funding. We have made real progress on key issues. Our government will work to complete the renewal process by the end of March 2004.

Also, last June the Government set out its response to the report prepared by this committee on bank mergers. In our response, building on the important work of this committee and the Senate Committee on Banking, Trade and Commerce, we clarified public interest considerations in reviewing bank merger proposals. We also explored other significant issues affecting the structure of the financial services industry as a whole. Public input on these issues is currently being received, and the Government is committed to delivering a new policy in June 2004.

All of these issues are important public policy matters. As always, they will require some difficult choices. But as the events of the past year have shown, we must be prepared to make these decisions to preserve our strong fiscal position, to continue to build confidence and to confront an increasingly competitive global economy.

Global Economic Developments

Let me turn now to the global economic picture. From a global perspective, 2003 has generally been a disappointing year. World growth remains unbalanced, with domestic demand in advanced nations outside North America generally quite weak.

The euro zone, which includes the 12 countries that use the euro currency, has seen another sluggish year. Germany, Europe's largest economy, barely saw any economic growth in 2002, and is not expected to grow at all this year. Most European countries have large fiscal deficits as well. In the period ahead the significant and protracted weakness in domestic demand in the euro zone is expected to continue.

Japan has experienced six consecutive quarters of growth, led by strong exports. However, domestic demand remains weak and consumer spending is essentially flat.

But as always, the country that looms largest on our economic horizon is the United States. The last two quarters suggest that a robust U.S. economic recovery is at last unfolding. Economic growth picked up in the second quarter, rising by a better-than-expected level of 3.3 per cent. In the third quarter it accelerated further to a very strong 7.2 per cent. Consumer demand and business investment have enjoyed broad-based strength, supported by fiscal stimulus, continued low interest rates and a weaker American dollar. Consumer demand has been particularly strong for big-ticket items such as automobiles and housing. With corporate profits rising in 2003, business investment appears to be picking up, especially investment in software and equipment.

In response to the large and persistent U.S. current account deficits, a broad array of currencies have appreciated against the U.S. dollar this year. These include gains of 11 per cent by the euro, 9 per cent by the yen and 25 per cent by the Australian dollar.

And while a strong fiscal stimulus is contributing to the acceleration of growth in the U.S., at the same time the combined deficit of federal and state governments is forecast to climb to more than 6 per cent of GDP this year. This could adversely affect market confidence.

Canadian Economic Developments

Madam Chair, let me now turn to Canada.

As I mentioned earlier in my presentation, recent developments in the Canadian economy have been dominated by a series of unforeseen challenges. Assessing the economic impacts of these challenges is not easy. Some evidence of the impacts of SARS and BSE can be found in a wide range of economic statistics. For example, the number of visitors to Canada in the second quarter declined by 15 per cent from the first quarter.

The export ban on Canadian beef imposed as a result of the single case of BSE led to a 10-per-cent drop in the output of the slaughtering and meat processing industries between April and June. The Ontario electrical blackout and its lingering impact were a significant factor behind a 4.5-per-cent decline in manufacturing shipments and a large decline in real exports and GDP in August. And we continue to assess the impacts of Hurricane Juan, that devastated Atlantic communities, and the forest fires and floods that hit Western Canada.

In addition, the sharp decline in the U.S. dollar has been mirrored by a strong upward surge in the value of our currency. Since the beginning of 2003 the Canadian dollar has risen in value by more than 20 per cent against the U.S. dollar. A higher dollar will affect businesses in Canada, as they adjust to the short-term effect on the profits of exporters and to lower foreign demand for higher-priced Canadian goods and services.

As a result of these shocks, the Canadian economy stalled in the second quarter. In the third quarter, which included the August blackout in Ontario, private sector economists are forecasting a rebound to about 2 per cent real growth.

Canadian job creation numbers reflect our challenges. After very strong job growth last year of more than 500,000 new jobs, employment numbers increased by 98,000 in the first nine months of this year, while the unemployment rate rose slightly to 8 per cent.

At the same time, Canada's inflation rate has declined more rapidly than most analysts had predicted earlier this year. The Consumer Price Index (CPI) inflation rate was 2.2 per cent in September. Core inflation, which excludes the most volatile components of the CPI, was down to 1.7 per cent from over 3 per cent at the beginning of this year.

Slower economic growth and the rapid decline in the rate of inflation have led the Bank of Canada to lower its target interest rate by 50 basis points since July. These lower rates will help support growth going forward.

Consumer and business confidence in the health of Canada's economy have remained strong. For example, the latest survey done by the Canadian Federation of Independent Business (CFIB) says that confidence among its members has recovered most of the ground lost earlier this year. Furthermore, it also indicates that CFIB members are now more positive about what they expect over the next 12 months.

Global Economic Outlook

Madam Chair, having reviewed where we are at, I would like to turn to where we are going, and our assessments of both the global and Canadian economic outlooks.

First, to the global outlook.

The IMF forecasts that the economies of the world's advanced nations will expand by 1.8 per cent this year, with growth rising to almost 3 per cent in 2004. Next year's forecast represents a significant improvement from the sluggish global economy of recent years.

In the euro zone, however, the short-term outlook remains quite weak. Growth of 0.5 per cent is expected in 2003, rising to 1.9 per cent in 2004.

In Japan, after a modest pickup to 2 per cent in 2003, growth is expected to slow to 1.4 per cent next year as that country deals with continued deflation and with persistent weakness in corporate and financial balance sheets.

In the U.S. the recovery seems to be on a more solid footing. Fiscal stimulus and low interest rates continue to support U.S. consumer demand. This, along with improved corporate profitability, will give firms the confidence and the means to invest and create new jobs. The decline in the value of the U.S. dollar will help fuel their recovery by making American exports more attractive.

Private sector economists have raised their forecast for U.S. growth in 2003 to 2.7 per cent and have also revised their growth forecast upward to 3.9 per cent for 2004. A strong U.S. economy is obviously good news for the world economy and for Canada in particular.

Canadian Economic Outlook

Madam Chair, let me now turn to the economic outlook for Canada.

The Department of Finance regularly surveys a group of private sector economists to get their views on Canada's economy. In the most recent survey, conducted in September, economists lowered their estimate of 2003 GDP growth to 1.9 per cent, down from the 2.2 per cent they forecast in June and the 3.2 per cent they anticipated at the time of the February 2003 budget.

However, private sector economists believe that a variety of factors should lead to an increase in economic growth over the balance of 2003 and through next year. These factors include continued strong U.S. growth, recent interest rate reductions by the Bank of Canada and a return to more normal output levels.

Historically low interest rates will support consumer spending and business investment. The Conference Board of Canada's Index of Business Confidence supports this view. It showed a strong rebound in the third quarter, with a large increase in the proportion of firms who expected economic conditions to improve in the next six months and who thought that now was a good time to invest.

Private sector economists now forecast real growth in Canada of 3 per cent in 2004. This is down from the 3.5-per-cent projection at the time of the February budget. The economists believe that the trade and other adjustments resulting from the rapid appreciation of the Canadian dollar will continue into next year. This is the main reason they have lowered their Canadian growth forecasts, even as they have revised upward growth estimates in the U.S.

It is also worth noting that the private sector economists we have surveyed expect Canadian economic growth to average about 3 per cent for the four years after 2004. This is largely unchanged from what was anticipated at the time of the February budget.

Reasons for Caution

Madam Chair, I am happy to say that these economic forecasts point to an improving picture for both the Canadian and global economies. But we must remain prudent. There are a number of uncertainties that could affect these forecasts in the months ahead.

First is the sustainability of the U.S. economic recovery. In the short term it depends upon a return to job growth. Without this, consumer demand could weaken, and investment would slow as companies lose faith in the durability of the recovery. As well, the growing U.S. fiscal imbalance will need to be addressed, or the rapidly rising debt could put upward pressure on world interest rates.

Second, private sector economists are of the view that a significant downside risk to the Canadian outlook is the impact of the appreciation of our dollar on the economy. Because of the extent and speed of the appreciation of the Canadian dollar, economists have told me that the impact of the appreciation may be greater than they have predicted.

All this being said, on balance Canada's economic fundamentals remain sound, and our economy remains well placed to show sustained growth over the medium term, even in this somewhat uncertain global environment.

Fiscal Progress Continues

Madam Chair, let us now turn to Canada's fiscal situation and outlook.

2002–03

First, I would like to deal with the fiscal results for 2002–03 and put them in an international context.

On October 22, the Government released its audited fiscal results for 2002–03. These results were presented for the first time on the full accrual basis of accounting. This is a major achievement and establishes Canada as a world leader in financial reporting. The Auditor General has strongly endorsed this change, as it presents a more comprehensive picture of the Government's financial position.

The surplus for 2002–03, on a full accrual basis of accounting, was $7.0 billion, marking the sixth consecutive year in which the federal government has been in surplus—something we have not seen in 50 years.

As a result of these surpluses, the federal debt has been reduced by $52.3 billion over the past six years. Let's understand what this means. We are saving $3 billion each year on interest payments that we can spend on other priorities for Canadians. As a result, for the first time in 19 years the federal government spent more on direct transfers to Canadians than we paid for interest on the public debt.

Also, the federal debt-to-GDP ratio has been reduced by nearly 25 percentage points, from its peak of 68.4 per cent in 1995–96 to its current level of 44.2 per cent.

Taking all levels of government together, Canada was the only G-7 country to be in surplus in 2002. Both the IMF and the Organisation for Economic Co-operation and Development estimate that Canada will again be the only major industrial country in surplus this year and next.

Canada's total public debt burden, as a share of the economy, is now the second lowest in the G-7, behind only the United Kingdom. This is a remarkable achievement when you consider that Canada had the second highest public debt burden among G-7 nations as late as the mid-1990s.

Madam Chair, it is important to note the reason behind the better-than-expected fiscal results last year. Budgetary revenues, primarily personal income tax revenues, came in lower than expected. This reflects the weaker-than-expected economy in the first months of this year. However, this was more than offset by lower-than-anticipated program expenses. These were principally attributable to one-time factors. But the weakness in the personal income tax revenues we witnessed toward the end of the 2002–03 fiscal year will carry forward to the current fiscal year.

2003–04

And the fiscal results to date for the current fiscal year confirm this fact. Fiscal results for the April to August period of 2003–04 show a cumulative surplus of $1.3 billion. This is less than half the surplus of $2.8 billion recorded over the same period last year.

Based on these results and private sector forecasts, our estimated surplus this year has been lowered to $3.5 billion, down from $4 billion estimated in the February budget. As you will recall, this $4 billion included $3 billion of Contingency Reserve and $1 billion of additional economic prudence.

As I mentioned earlier, Canada has been faced this year with a series of unforeseen challenges that have required the federal government to act. Since the February budget we have announced $1.2 billion in new spending this year to meet these challenges. This includes measures to assist those Canadians most affected by SARS and BSE. It also includes additional spending on our international obligations, including support for the role our troops are playing in Afghanistan.

After taking into account the cost of these measures, this leaves us with an estimated budgetary surplus of $2.3 billion for 2003–04. This means there is $2.3 billion left in what was a $3-billion Contingency Reserve to ensure that we meet our commitment to achieve a balanced budget.

Madam Chair, last February the Prime Minister and the provincial premiers and territorial leaders reached a historic accord on health. As part of this accord, the Prime Minister agreed to transfer up to an additional $2 billion, provided the federal surplus was more than the $3-billion Contingency Reserve this fiscal year. Notwithstanding the conditional nature of this agreement, we now know that many provinces have already earmarked this money for spending on health care.

As we have seen, the revised fiscal projections suggest that it is unlikely that the federal government will see a surplus of more than the $3-billion Contingency Reserve this year. Despite this fact, the Prime Minister has written to the provincial premiers and territorial leaders today to inform them that, if there is any federal surplus this year, we will provide up to the first $2 billion of it for health care spending when we close the books. This is an important decision—one that addresses a top priority for Canadians, while promoting the spirit of co-operation that is central to the accord on health.

Let me stress again, we will not run a deficit this year. Our commitment to balancing Canada's books remains the cornerstone of our fiscal planning.

Madam Chair, this is a one-time change of policy in regard to the Contingency Reserve. Reducing Canada's overall indebtedness continues to be an important priority for the federal government moving forward. But Canadians expect us to make responsible, prudent choices when dealing with unforeseen circumstances. We are doing that this year.

2004–05 to 2008–09

I would now like to turn to the medium-term fiscal outlook. But before doing so, allow me to remind committee members of how these projections were arrived at.

The Department of Finance surveys private sector economists every quarter and uses their average economic forecasts as the basis for our fiscal planning. For this Update, four macroeconomic modelling firms used these forecasts to generate fiscal projections for the next five years.

Over this period, before making any allocation for prudence, the average private sector projections forecast a surplus of $3.0 billion in both 2004–05 and 2005–06, $4.0 billion for 2006–07, $6.0 billion for 2007–08 and $9.5 billion for 2008–09. These figures include the cost of measures announced since the February budget.

Madam Chair, the figures I have just outlined show that in the short term Canada faces a period of relatively modest fiscal surpluses as we deal with a weaker economic outlook. These surpluses will allow us to set aside the normal $3-billion Contingency Reserve every year. However, there will be no additional economic prudence until the third year of the forecast period.

The reason for this is quite simple. While private sector economists have substantially lowered their forecast for economic growth this year and next, they have not changed their views about the growth prospects over the medium term. This means the loss of production and income resulting from weaker growth this year and next is not expected to be made up by stronger growth in the near future. This, in turn, means that national income—the broadest measure of the Government's tax base—is expected to be lower throughout the five-year projection period than the economists anticipated at the time of the February budget.

Madam Chair, I believe this underscores the importance that we must place on our annual reallocation efforts. These efforts will be crucial if we are to continue to be able to address the highest priorities of Canadians and respond effectively to unforeseen shocks, as we have this year. We must strive to restore our normal prudence as soon as possible. And we must continue to find savings by improving the way the federal government manages and spends taxpayers' dollars.

Nevertheless, it should be remembered that without the fiscal discipline of the last several years, we would be facing a real deficit situation and a return to a growing national debt—a burden that would continue to weigh even more heavily on future generations. And over the long term I believe this would pose the single biggest threat to our ability to spend on the programs that Canadians want and need.

Thankfully, that is not the case today. In fact, our national finances remain in the black and are forecast to do so in the foreseeable future. We are the only G-7 country in that position. This Canadian advantage is a direct result of the progress we have made over the past 10 years to put Canada's finances back on track and keep them there.

A Decade of Progress

Madam Chair, 10 years ago Canadians elected a new government. They entrusted us to take the actions that were needed to provide a better future for themselves and their children.

Together, Canadians have come a long way. We can take great pride in the progress we have made—progress achieved through the determination, hard work and dedication of Canadians across our country.

But to fully appreciate how far we have come as a country, we need to remember where we were 10 years ago. As I mentioned earlier, 10 years ago our economy was in crisis. Our government inherited a disastrous economic situation—high unemployment, low growth, high deficits and low confidence. A decade ago it was virtually impossible to imagine how our nation might come so far, so fast.

Who honestly believed that within 10 years we could erase an annual budgetary deficit of $38 billion, produce six consecutive surpluses and reduce our net debt by more than $50 billion?

Who thought we would have been able to implement a five-year $100-billion tax cut plan, amounting to the largest cuts in Canada's history?

Who thought our corporate tax rates would be lower, on average, today than those in the United States? This is an important element in attracting new investment to Canada, which helps create jobs and fuels economic growth.

Who believed that we would be able to commit to substantial increases in the National Child Benefit, boosting funding for kids by more than $5 billion by 2007 and helping to reduce the number of Canadian children living in poverty?

Who would have conceived that we would be able to place the Canada Pension Plan on a sound financial footing for the next 50 years—thereby guaranteeing that the current and future generations of working Canadians will be provided with the means to live in comfort and dignity when they retire?

Who thought we would see record job growth and economic expansion to the point that today there are 3 million more people working in Canada than in 1993?

Who would have forecast that, over the past six years, Canada's GDP per capita, which represents the best measurement of a nation's standard of living, would grow by 20 per cent? This is the fastest level of growth in the G-7.

Who would have predicted that we could invest an additional $63 billion to strengthen our health care system based on accords with the provinces and territories?

Who dared to think that by now Canada would have seen the largest investment ever—$13 billion—in research and innovation, turning Canadian universities into world leaders in the pursuit of knowledge, new ideas and development of cutting-edge technology?

All that, and much more, Canadians have achieved in 10 short years. Yes, we called upon Canadians to make sacrifices. And it was painful for people who felt the impact of cuts as we came to terms with our financial situation. As the then Minister of Industry, I had to cut my budget by 50 per cent, in the process laying off hundreds of excellent public servants, many of whom lived in my community here in the national capital. I know first-hand the sacrifices that people made.

But the bottom line is clear—the Canada that we know today is a very different and much better place in which to live, work and invest. It is a Canada that is rapidly shedding the burdens of the past and is poised to take full advantage of the opportunities of the future.

Certainly, there are still major issues we must tackle and pressing needs that must be addressed. Our work is not finished. There remains much to do if we are going to build a more innovative, more intelligent, more inclusive and more international Canada for our children and grandchildren.

Still, we can be certain that the fiscal path we are on is the right one. It has taken us far. And it will take us even further as we build an even better Canada for all Canadians.

Conclusion

Madam Chair, this has been a year of trial and tribulation. It has tested the resolve of many Canadians from coast to coast.

Despite the shocks we have experienced, Canada's fiscal balance remains intact and our economy is poised to benefit from the general global upswing in the months ahead.

But balance sheets alone don't tell the story of Canada in 2003. I believe the real story is found in the spirit shown by Canadians time and time again this year in the face of crisis. Through the fires, the floods and the blackout, through SARS and BSE, through the ongoing challenges found in farming, forestry and fisheries, Canadians have responded with compassion and resolve.

It is a spirit born of a newfound confidence and driven by a strong sense of purpose and a determination to excel. It is the kind of spirit that allowed us to meet the great economic and fiscal challenges of the last decade. And, Madam Chair, it is the kind of spirit that will make Canada a model of prosperity and security in the 21st century.

Annex 1

Canadian Economic and Fiscal Progress: The Last Ten Years[1]

[1] Incorporates data available up to October 28, 2003.

Highlights

- *The Government has recorded six consecutive budget surpluses since 1997–98 and has reduced the federal debt by more than $52 billion. This has freed up some $3 billion a year in interest savings, which can now be used for other priorities. Canada's fiscal turnaround exceeds that of any other Group of Seven (G-7) country. As a result, Canada's total debt burden moved from being the second highest in the G-7 in the mid-1990s to the second lowest.*

- *Thanks to fiscal discipline, the Government was able to implement the largest tax cut in Canadian history and to create a growing tax advantage for Canadian businesses that will foster economic growth and job creation. Canada's fiscal achievement, combined with its low and stable inflation record, helped to keep interest rates low and stimulate investment and productivity.*

- *To support an increasingly knowledge-intensive economy, the federal government has made significant investments in education and skills, research and development, and knowledge creation.*

- *Over the last six years Canada has been a G-7 leader in labour productivity growth. Furthermore, the Canadian economy has created more than 2 million jobs since 1996, the best job creation record in the G-7, narrowing Canada's unemployment gap with the United States from nearly 5 percentage points in 1996 to 2 percentage points today.*

- *A strong economic performance is key to the sustainability of Canada's social safety net and to the ability of governments to invest in priority areas.*
- *The federal government has made significant investments in Canada's social programs through increased cash transfers to the provinces, income assistance for children in lower-income families, and initiatives to promote healthy communities. Canada has also achieved major successes in putting the "three pillar" retirement income system on a sustainable financial footing.*
- *Improved fundamentals have led to renewed strength in gross domestic product (GDP) growth since the second half of the 1990s. After slowing through the 1970s and 1980s and virtually stalling in the early 1990s, real GDP per capita rose by 20 per cent over the 1997 to 2002 period.*

Introduction

- Fiscal and Monetary Progress
  - Chronic deficits have become sustained surpluses
  - Debt placed on a downward track
  - Inflation targeting generated low and stable inflation
  - Fiscal and monetary policy credibility led to lower interest rates
- Policy Progress
  - Investments in key social and growth initiatives
  - $100-billion tax reduction
  - Canada Pension Plan/Quebec Pension Plan put on an actuarially sound foundation
  - Investments in research and innovation
- Economic Progress
  - Stronger productivity growth supported by investment in human and physical capital
  - Reduced unemployment and higher job creation
  - Renewed growth in the economy and living standards of Canadians

- The 20 years between the mid-1970s and the mid-1990s were characterized by declining growth rates of real GDP, productivity and real household income. Inflation soared in the 1970s and 1980s along with a simultaneous rise in the unemployment rate. Years of chronic government deficits pushed Canada's debt–to-GDP ratio to levels well above the G-7 average.

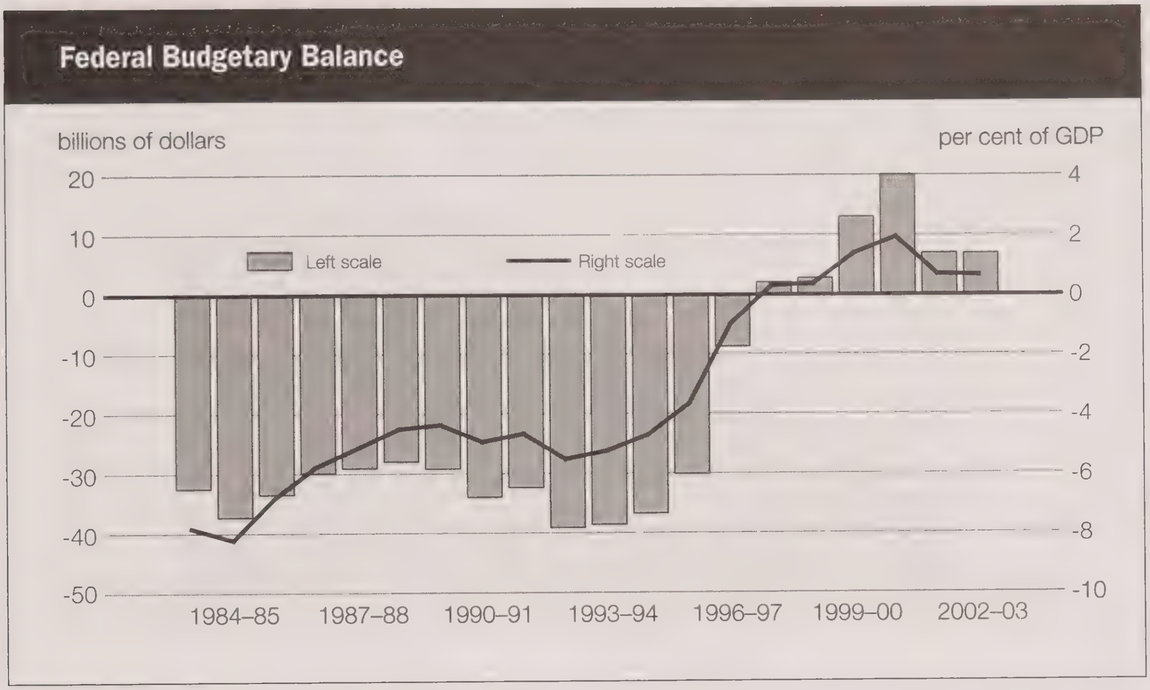
- Key reforms in the 1990s created a stable fiscal and monetary climate in Canada. Large and growing deficits were replaced by sustained surpluses through expenditure reduction and prudent budget planning. After rising for more than 20 years, Canada's total government debt burden was placed on a permanent downward track. Today, of the G-7 countries, only Canada remains in a surplus position, while only the United Kingdom has a lower debt burden.

- Monetary policy reform in 1991, when the Bank of Canada and the Government of Canada agreed to adopt inflation targets, has complemented and strengthened policy reform elsewhere. The resulting low and stable inflation facilitated long-term planning and encouraged business investment that ultimately contributed to higher productivity growth.

- These macroeconomic reforms supported and enabled important microeconomic reforms that further fuelled economic growth and job creation, and provided the resources to allow us to invest in strengthening a society that Canadians value. The changes involved substantial tax reductions, improved labour market policies, a sustainable public pension system, reforms to business subsidies and business framework policies, financial sector reform and reduced barriers to trade. At the same time, important investments have been made in families and their communities, the health care system, skills development, and research and innovation.

- The macroeconomic and microeconomic reforms implemented in Canada, together with favourable economic conditions, have contributed to higher productivity growth and a stronger labour market. These developments have led to renewed growth in Canadian living standards and will continue to raise the quality of life of Canadians.

Canada's fiscal progress—six consecutive federal budget surpluses since 1997–98

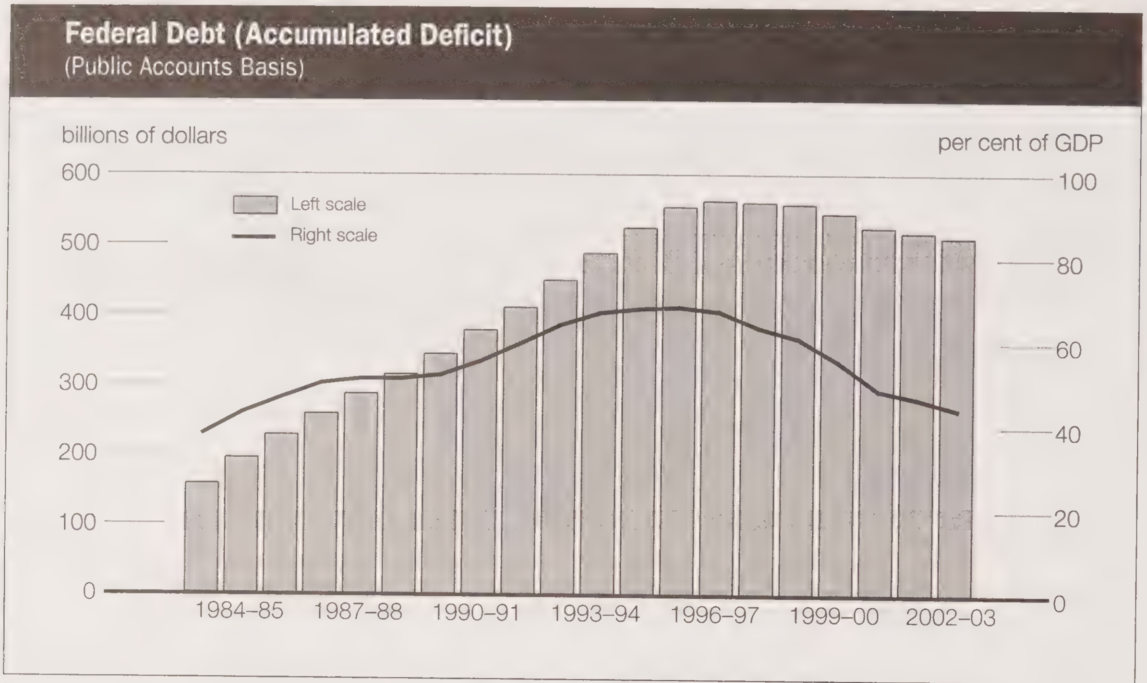


Sources: *Public Accounts of Canada* and Statistics Canada.

- From the early 1980s to the mid-1990s the federal deficit was stuck at around $30 billion or more per year. However, with the structural reforms introduced principally in the 1995 and 1996 budgets, the deficit was eliminated and a surplus was recorded in 1997–98—the first surplus after 27 consecutive years of deficits.

- The federal government has now posted six consecutive annual surpluses since 1997–98. Only once before has this been accomplished—in the period following World War II (1945–46 to 1951–52).

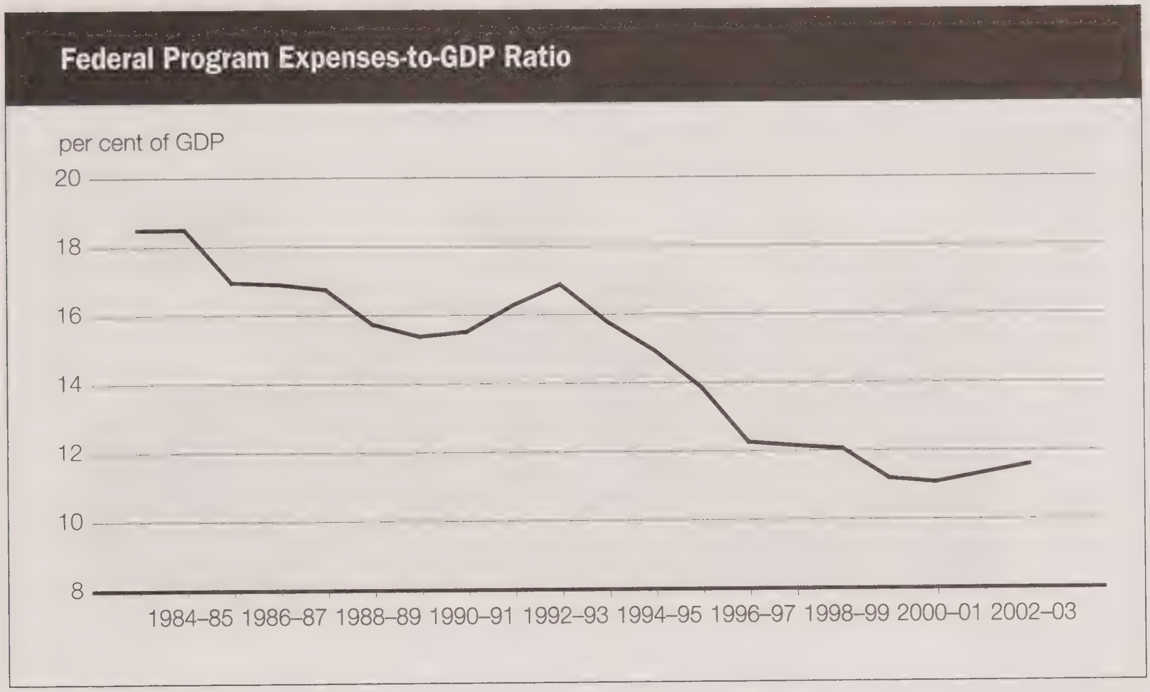
Federal debt-to-GDP ratio on a downward track



Sources: *Public Accounts of Canada* and Statistics Canada.

- As a result of these surpluses, the federal debt (accumulated deficit) has been reduced by $52.3 billion since 1997–98.
- The federal debt-to-GDP ratio fell to 44.2 per cent in 2002–03. It has come down almost 25 percentage points from its peak of 68.4 per cent in 1995–96.

Decline in federal program expenses a major contributor to fiscal consolidation



- The federal program expenses-to-GDP ratio has declined significantly, from 15.7 per cent in 1993–94 to 11.5 per cent in 2002–03. This decline is largely attributable to the expenditure reduction initiatives, announced in the 1995 and 1996 budgets, aimed at eliminating the deficit.

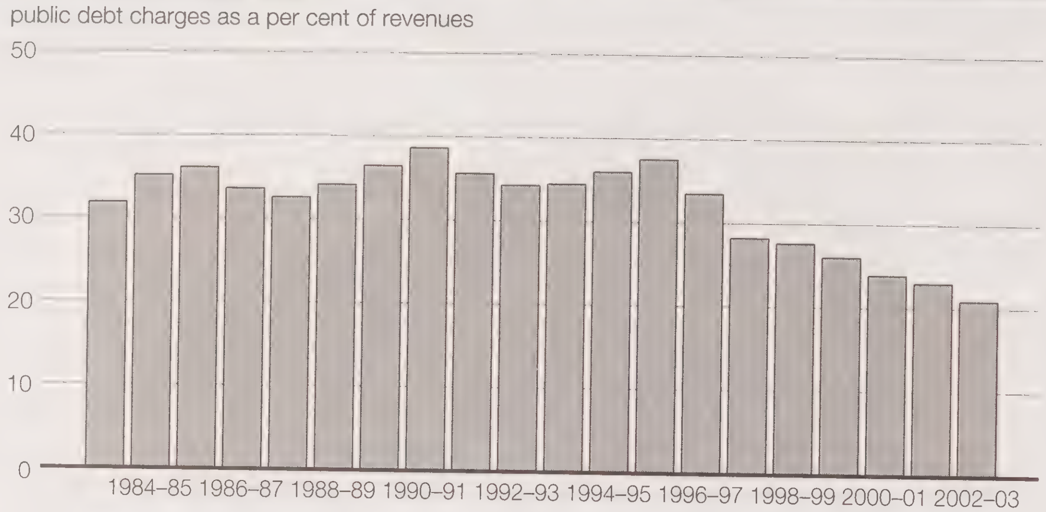
- The decline in program expenses as a percentage of the economy was the major contributor to the elimination of the deficit and the emergence of six consecutive years of budgetary surpluses.

- Between 1993–94 and 2002–03 program expenses as a share of GDP fell by 4.2 percentage points, while public debt charges as a share of GDP were reduced by 2.3 percentage points. The resulting 6.5-percentage-point improvement in the budget balance as a share of GDP was partially offset by a 0.6-percentage-point reduction in revenues as a share of GDP.

- In total, the improvement in the budgetary balance as a percentage of GDP between 1993–94 and 2002–03 was 5.9 percentage points—moving from a deficit of 5.3 per cent to a surplus of 0.6 per cent.

Reduction in federal debt means more resources for other priorities

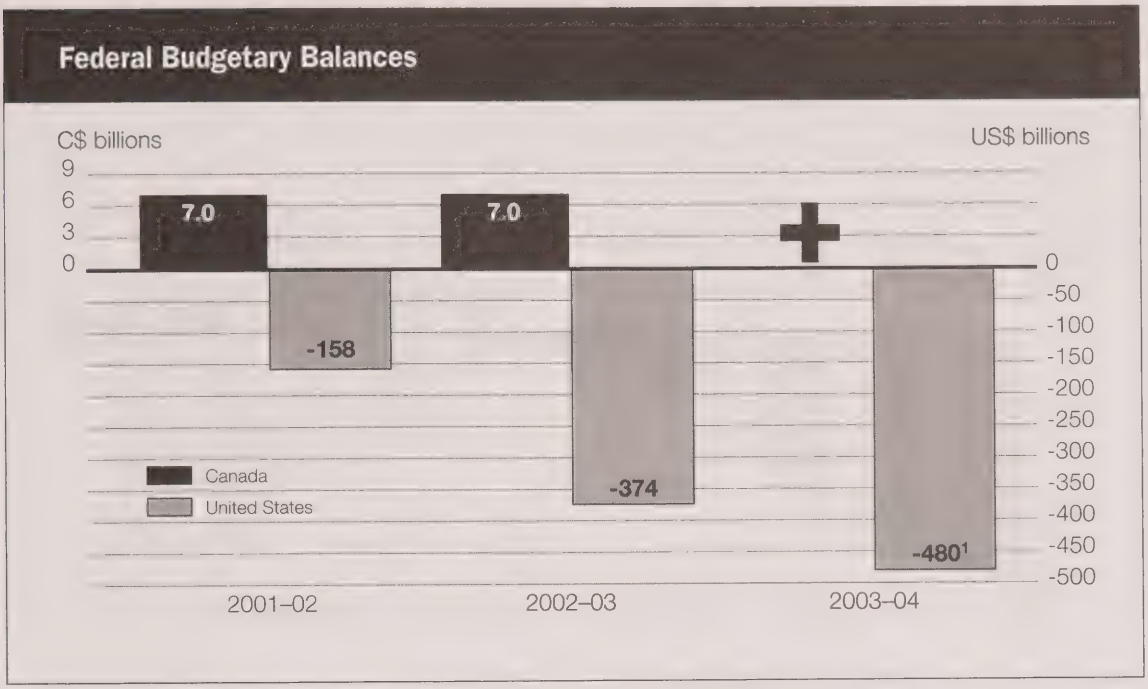
Interest Ratio



Source: Department of Finance.

- The federal debt has been reduced by $52.3 billion over the last six years, resulting in ongoing savings in public debt charges of about $3 billion annually.
- In 1995–96 37.6 cents of each revenue dollar went to service the debt. Today it has dropped to 21 cents.
- This means that more of each revenue dollar can be used to address the key priorities of Canadians.

Relative fiscal performance: Canada has maintained fiscal surpluses despite global slowdown; large deficits in U.S.



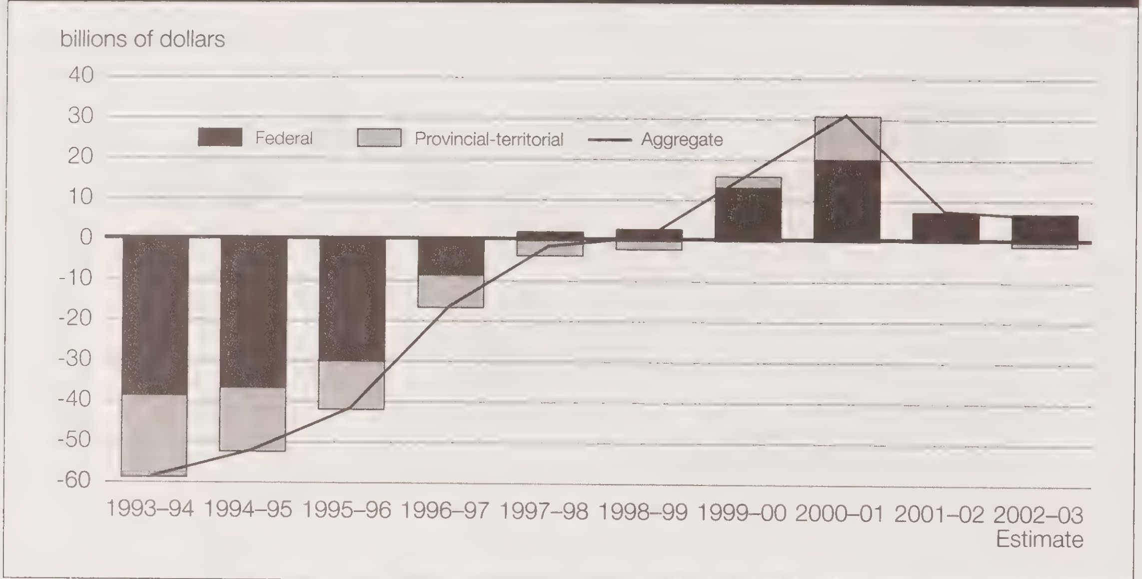
[1] Congressional Budget Office, August 2003.

Sources: Canada: *Annual Financial Report of the Government of Canada*, October 2003; U.S.: Department of the Treasury, October 2003.

- In 2000–01 both Canada and the United States recorded surpluses.
- However, the federal government in the United States posted large deficits in both 2001–02 and 2002–03, and is expected to record another deficit in 2003–04.
- In contrast, Canada's fiscal situation remained in surplus in both 2001–02 and 2002–03, and a balanced budget or better is expected in 2003–04.

Both the federal and provincial-territorial governments have contributed to the significant improvement in Canada's fiscal situation

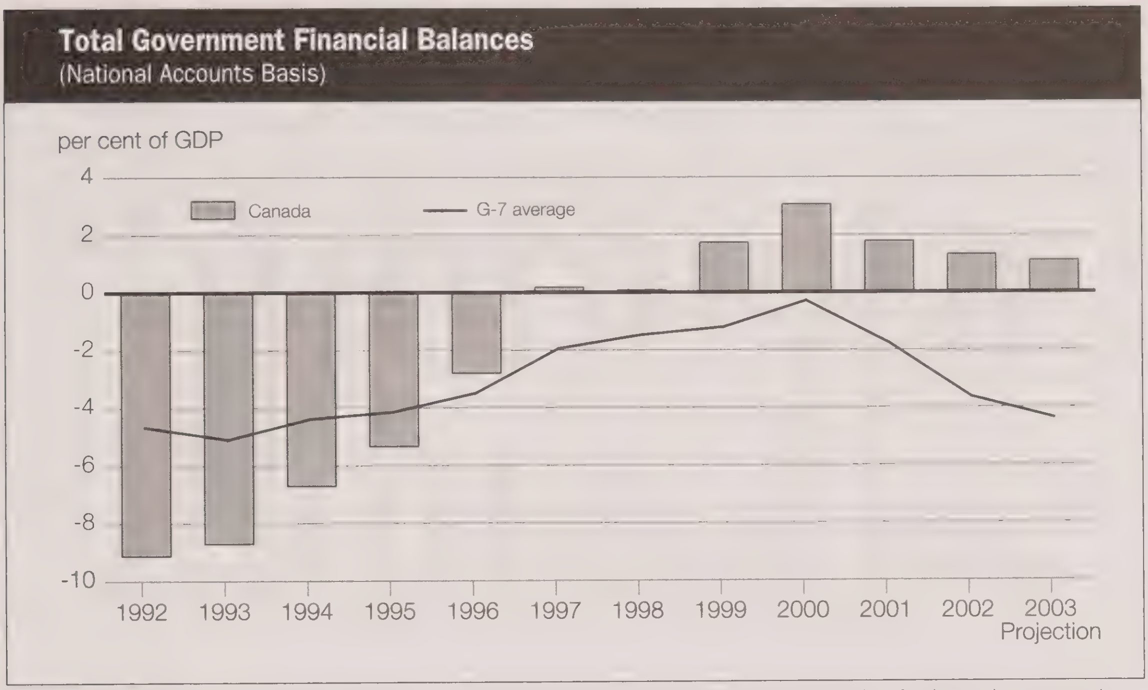
Federal and Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



Sources: Federal and provincial-territorial Public Accounts and budgets.

- Both the federal and provincial-territorial governments have contributed to turning Canada's fiscal situation around.
- For the federal-provincial-territorial governments as a group, a combined deficit of nearly $60 billion in 1993–94 turned to surplus in 1998–99 and has remained in surplus since.
- This improved fiscal performance has helped underpin Canada's solid economic performance, and allowed the Canadian economy to better withstand the global shocks that occurred over this period.

Canada's total government fiscal turnaround exceeds that of any other G-7 country



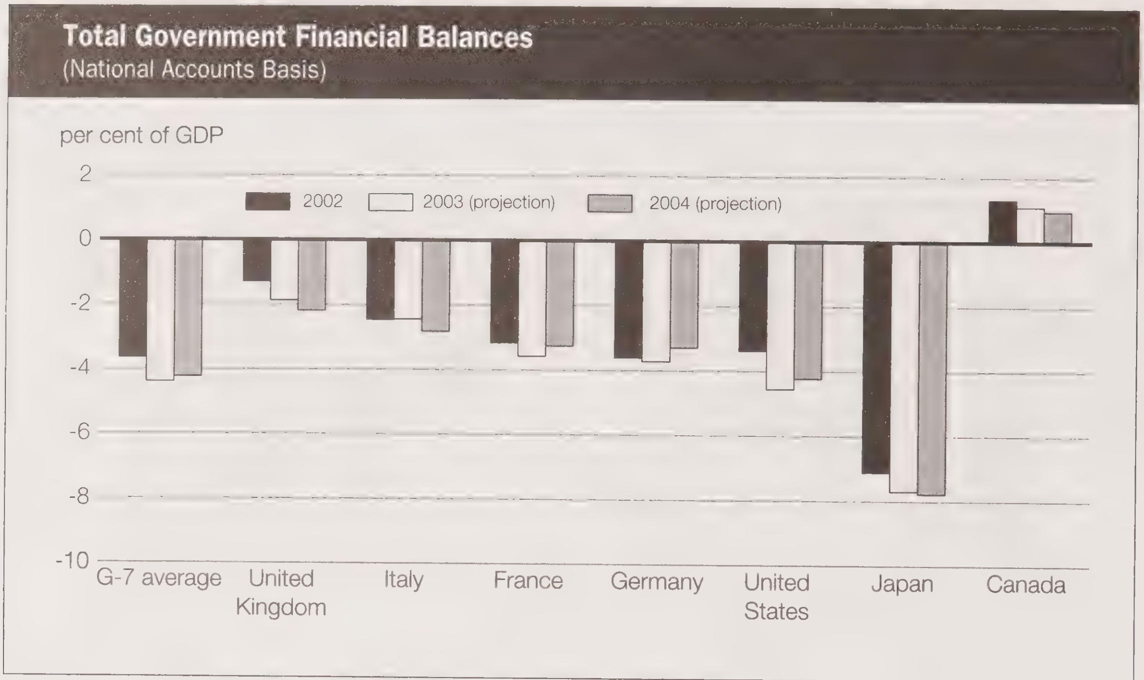
Note: International fiscal comparisons are based on the standardized System of National Accounts data for the total government sector to take into account differences in accounting methods among countries, which affect the comparability of data, and differences in financial responsibilities among levels of government within countries.

Sources: *OECD Economic Outlook,* No. 73 (June 2003), Department of Finance calculations.

- The improvement in Canada's fiscal performance has exceeded that of the U.S. and all other G-7 countries over the last 10 years.
- In 1992 Canada's total government deficit,[1] measured on a National Accounts basis (the measure commonly used to make comparisons across countries), peaked at 9.1 per cent of GDP, almost double the G-7 average. By 1997, however, significant fiscal improvements at all levels of government and measures to reform the Canada Pension Plan and Quebec Pension Plan enabled Canada's total government sector to post a surplus, and to remain in surplus each year since.
- Canada has recorded six consecutive surpluses. The Organisation for Economic Co-operation and Development (OECD) currently expects that Canada will post a seventh consecutive total government surplus in 2003, equal to 1.1 per cent of GDP. The G-7 countries, on average, are expected to post a deficit of 4.4 per cent of GDP.

[1] Includes federal, provincial-territorial and local governments as well as the Canada Pension Plan and Quebec Pension Plan.

Canada is the only G-7 country to maintain a financial surplus despite the global slowdown

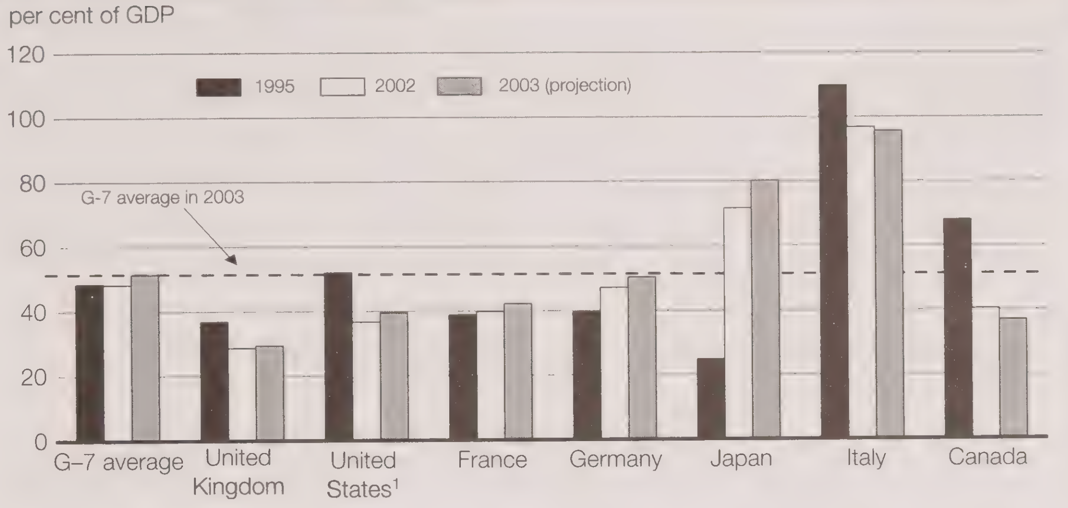


Sources: *OECD Economic Outlook,* No.73 (June 2003), Department of Finance calculations.

- The strength of Canada's fiscal and economic position was demonstrated during the global economic slowdown that began in 2001, when most G-7 countries experienced considerable pressure on their finances.
- Indeed, Canada was the only G-7 country to record a surplus in 2002 and is expected to be the only one to post a total government surplus again this year and next, according to OECD estimates.

Canada's debt burden has fallen from second highest to second lowest among G-7 countries

Total Government Net Financial Liabilities
(National Accounts Basis)



[1] Adjusted to exclude certain government employee pension liabilities to improve comparability with other countries' debt measures.
Sources: *OECD Economic Outlook*, No. 73 (June 2003), Federal Reserve, *Flow of Funds Accounts of the United States* (September 2003), Department of Finance calculations.

- Given the sharp turnaround in Canada's fiscal situation relative to the other G-7 countries, it is not surprising that Canada has also achieved the largest decline in government debt among G-7 countries.
- Between 1995 and 2002 Canada's total government sector debt-to-GDP ratio fell by 27.6 percentage points to 40.4 per cent of GDP.
- As a result, according to the OECD, Canada's total government debt burden moved from being the second highest in the G-7 in 1995 to the second lowest in 2003, lower than that of the U.S. Only the United Kingdom is expected to have a lower total government sector net debt burden than Canada this year.

Thanks to fiscal discipline, the Government has delivered significant tax relief to all Canadians

Federal Five-Year Tax Reduction Plan

	2000–01	2001–02	2002–03	2003–04	2004–05	Total
			(billions of dollars)			
Personal income tax	6.2	12.7	15.6	18.3	22.3	75.2
Corporate income tax	–	0.6	1.9	3.2	4.4	10.1
Employment insurance	1.5	2.5	3.0	3.8	4.4	15.2
Total	7.7	15.9	20.5	25.3	31.1	100.5

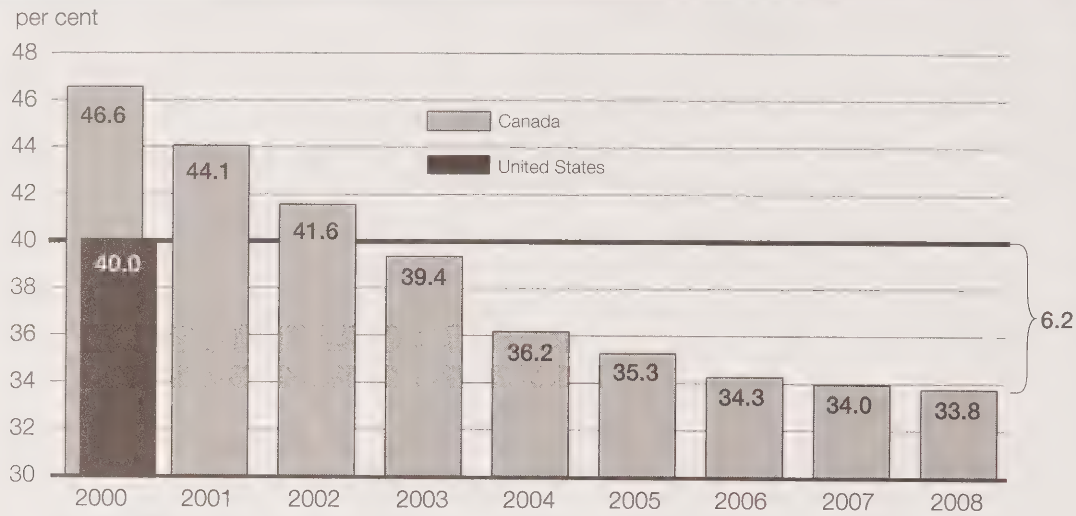
Note: Numbers may not add due to rounding.

- The Government began to deliver broad-based tax relief when the deficit was eliminated.
- In 2000 it introduced a $100-billion Five-Year Tax Reduction Plan—the largest tax cuts in Canadian history. This plan significantly reduces the tax burden of Canadian families and individuals.
  - About three quarters of the tax relief provided under this plan goes toward reducing the tax burden of Canadian families and individuals.
  - All tax rates have been reduced and the Canada Child Tax Benefit (CCTB) has been enhanced.
  - By 2004–05 the plan will have reduced the personal income tax burden by 21 per cent on average. Families with children benefit even more—with average tax savings of 27 per cent.
  - The employment insurance premium rate was reduced from $2.55 in 1999 to $2.10 in 2003. The rate is scheduled to fall to $1.98 in 2004, resulting in ongoing annual savings to employers and employees.

- The 2003 budget built on the Five-Year Tax Reduction Plan and enhanced support for Canadian families.
  - The CCTB has been further enhanced to support families with children. The maximum annual benefit for a first child under the CCTB will have more than doubled from $1,520 in 1996 to $3,243 in 2007.
  - The 2003 budget also introduced a new Child Disability Benefit for low- and modest-income families.
- As a result of the tax changes introduced since 1997:
  - A typical one-earner family of four earning $40,000 will pay $3,238 less in net federal personal income tax in 2007—a savings of 83 per cent.
  - A typical two-earner family of four earning $60,000 will pay $3,059 less in net federal personal income tax—a savings of 48 per cent.
  - Over 1.5 million Canadians will have been removed from the tax rolls.

The Government has also been able to create a tax advantage for Canadian businesses and entrepreneurs

Corporate Income Tax Rates: Canada vs. U.S.[1]
(Including Capital Tax Equivalents)

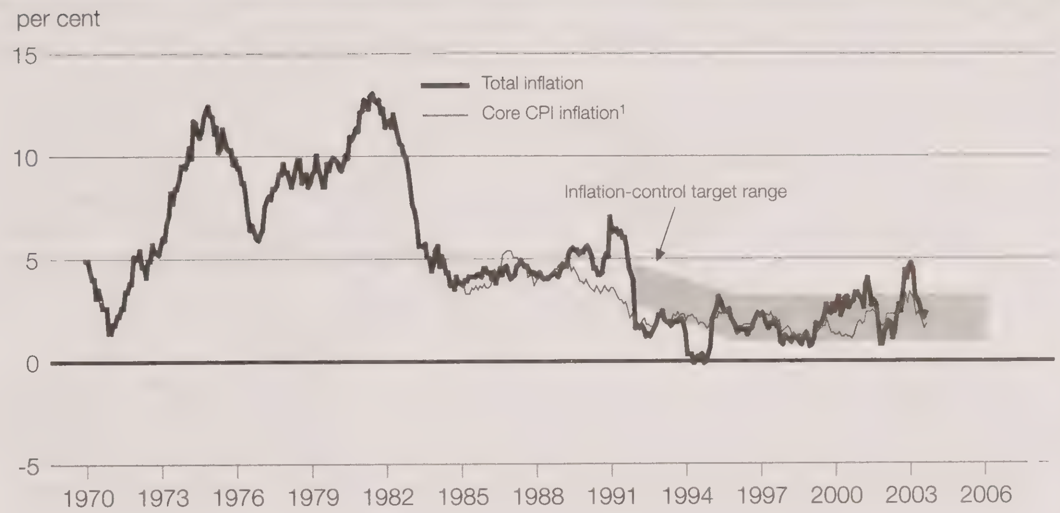


[1] Data for 2003 through 2008 include federal and provincial corporate income and capital tax changes as of September 30, 2003, that are legislated with a specific timetable for implementation.
Source: Department of Finance.

- The Five-Year Tax Reduction Plan and Budget 2003 have contributed to a Canadian tax advantage:
  - The Five-Year Tax Reduction Plan reduces the general federal corporate tax rate from 28 to 21 per cent by 2004.
  - Further to the 2003 budget, the elimination of the federal capital tax over five years has been legislated.
  - The 2003 budget also introduced a new taxation regime for the resource sector.
- By 2008 the average Canadian corporate tax rate will be significantly lower than the average U.S. rate.
- The investment climate for entrepreneurs and small businesses has also been improved.
  - The Five-Year Tax Reduction Plan reduced the capital gains inclusion rate from three quarters to one half and introduced a measure that allows individuals to defer the tax on capital gains from the sale of shares in an eligible small business corporation where proceeds are reinvested in another eligible small business.
  - The 2003 budget increased the amount of annual income eligible for the 12-per-cent small business rate from $200,000 to $300,000.

Canada has achieved a consistent record of low and stable inflation...

Total and Core CPI Inflation



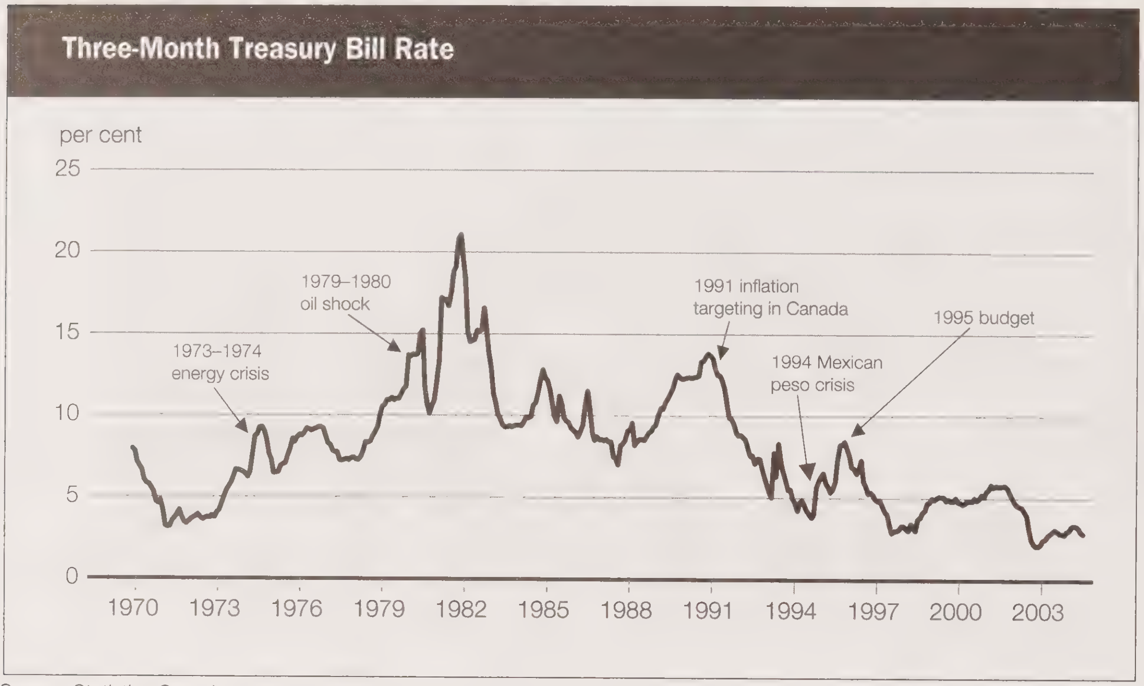
[1] Core Consumer Price Index (CPI) inflation is the all-items CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components, as defined by the Bank of Canada.
Source: Statistics Canada.

- A new monetary framework has complemented and strengthened reform on the fiscal front. In 1991 the Bank of Canada and the Government of Canada agreed to adopt an inflation-targeting regime. The target range was reduced to between 1 and 3 per cent and was extended several times, most recently in May 2001 to the end of 2006.

- Over the 1993 to 2002 period average inflation in Canada was 1.8 per cent—one of the lowest rates among G-7 countries and very close to the mid-point of the target range of 1 to 3 per cent.

- Low and stable inflation has facilitated long-term planning and encouraged business investment that has ultimately contributed to higher productivity growth. Equally important, the inflation-control targets have contributed to macroeconomic stability, preventing a recurrence of the inflationary "boom-and-bust" cycles of the early 1980s and early 1990s.

...which, together with fiscal discipline, has contributed to lower interest rates



Source: Statistics Canada.

- The credibility of Canada's monetary policy, complemented by a sharp improvement in the fiscal situation, increased the Bank of Canada's flexibility to respond quickly and decisively to changing economic conditions.

- The 1995 budget announced major reductions and restructuring of federal spending. It established a credible path toward the elimination of the deficit and set the debt-to-GDP ratio on a clear downward track.

- By eliminating the deficit and moving to sustained fiscal surpluses after 1997, Canada improved its international fiscal credibility, leading to reductions in risk premiums and interest rates.

- Lower interest rates have in turn reduced the debt burden, while providing strong support to interest-sensitive sectors such as housing, consumer expenditures and business investment.

Budget surpluses have reduced borrowing in capital markets, freeing resources for the private sector

Net Borrowings in Capital Markets

	1992–93	2001–02	Change
	(average) (billions of dollars)		
Government[1]	+45.1	-10.3	-55.4
Business[2]	+22.0	+59.1	+37.1

Note: Net borrowings in Canada and abroad.

[1] Net issues of total government bonds.

[2] Net issues of corporate bonds, equities and trust units.

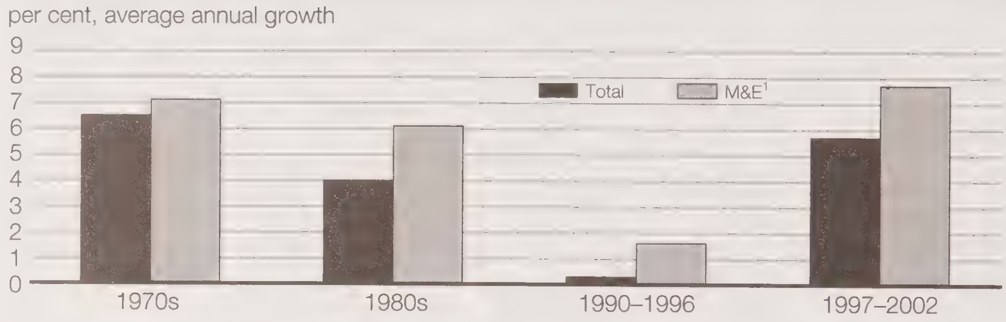
Source: Bank of Canada.

- With the elimination of budget deficits by federal and provincial governments, the government sector became a net lender in capital markets by 2001–02 after borrowing heavily in the early 1990s. At that time businesses, crowded out of the market by the financial needs of governments, borrowed much less for investment purposes.

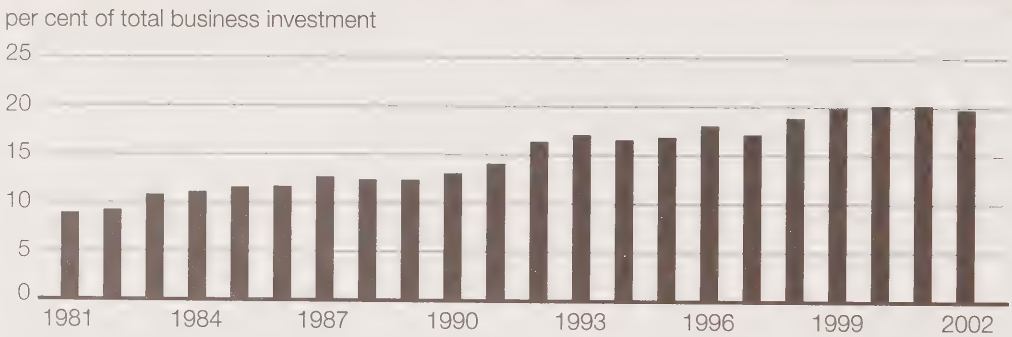
- With the government sector no longer a net borrower on capital markets, a much larger pool of savings has become available for the private sector to invest in productive endeavours.

Greater access to capital, lower interest rates and an improved fiscal environment have led to a rebound in business investment

Growth in Real Business Investment



ICT[2] Investment



[1] Machinery and equipment.
[2] Information and communications technologies.
Source: Statistics Canada.

- Encouraged by greater access to capital, lower and more stable interest rates, and a strong economic and fiscal environment, growth in business investment rebounded strongly to an average of 5.7 per cent per year over the 1997 to 2002 period, compared to 0.3 per cent during the first half of the 1990s.
- The increase in business investment, in turn, provided the foundation for job creation, productivity growth and a stronger economy.
- The recovery in business investment was led by rapid growth in real machinery and equipment (M&E) spending. Higher investment in information and communications technologies (ICT) was an important source of this recent growth. The share of ICT investment in total business investment doubled between 1981 and 2002.
- Investment in M&E, particularly ICT, frequently embodies new technologies and, as such, is an important element in productivity gains in the long run.

Since balancing the budget, the federal government has invested substantial resources in research and development (R&D) and knowledge creation

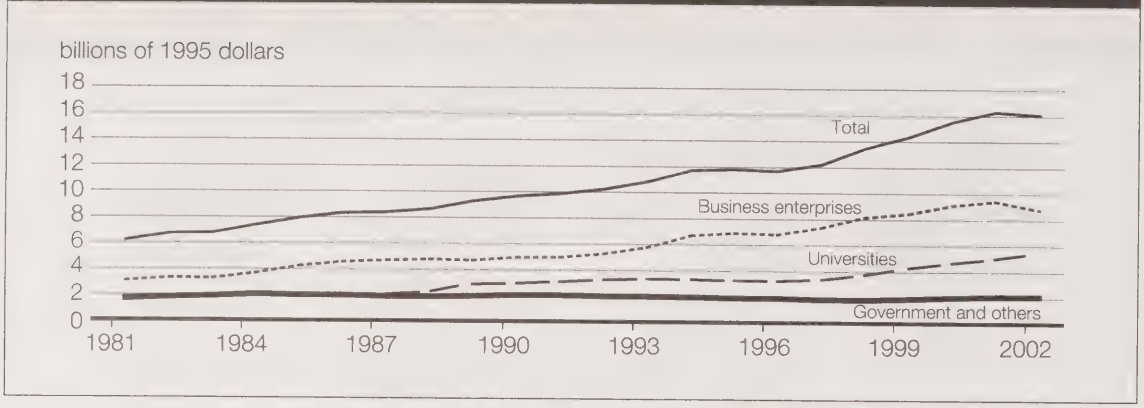
Innovation and R&D Initiatives

- ✓ Canada Foundation for Innovation and Genome Canada
- ✓ Canadian Institutes of Health Research
- ✓ Federal granting councils
- ✓ Indirect costs of research
- ✓ 2,000 Canada Research Chairs
- ✓ National Research Council: Industrial Research Assistance Program, regional innovation centres and Technology Partnerships Canada
- ✓ Investments in the Business Development Bank of Canada in support of venture capital
- ✓ Connecting Canadians through SchoolNet, the Community Access Program, Government On-Line and other initiatives

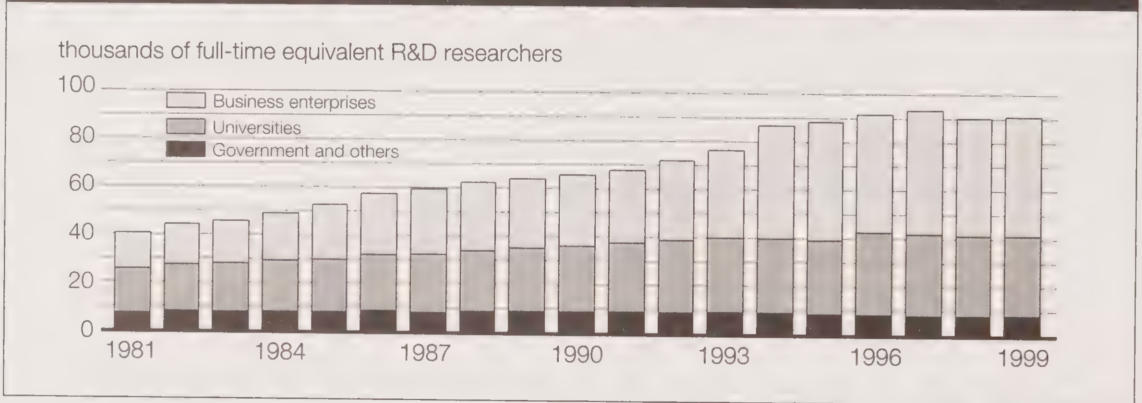
- Between 1998–99 and 2004–05 the Government increased funding on R&D and innovation by a cumulative total of $12.7 billion.
- Major investments have included:
  - The creation of the Canada Foundation for Innovation to support leading-edge research equipment and facilities.
  - The creation of the Canadian Institutes of Health Research, and the provision of substantial new resources to it and the other federal research granting councils.
  - The creation of the Canada Research Chairs Program to help universities attract and retain high-quality researchers.
  - The introduction of an ongoing program to support the indirect costs of federally sponsored research at universities, colleges and research hospitals.
  - Additional investment in Industry Canada, Technology Partnerships Canada and the National Research Council to encourage R&D, and in the Business Development Bank of Canada for venture capital to help knowledge-based companies grow and prosper.
  - Significant funding for programs aimed at connecting Canadians to sources of information and knowledge, including SchoolNet, the Community Access Program and Government On-Line.
- Canada's scientific research and experimental development (SR&ED) tax incentive program to promote spending on R&D is available to every industrial sector and is one of the most advantageous R&D tax systems in the industrialized world.

In response to these federal initiatives, both universities and business have engaged more actively in R&D

Real Spending on R&D by Sector



Total Research Scientists and Engineers by Sector

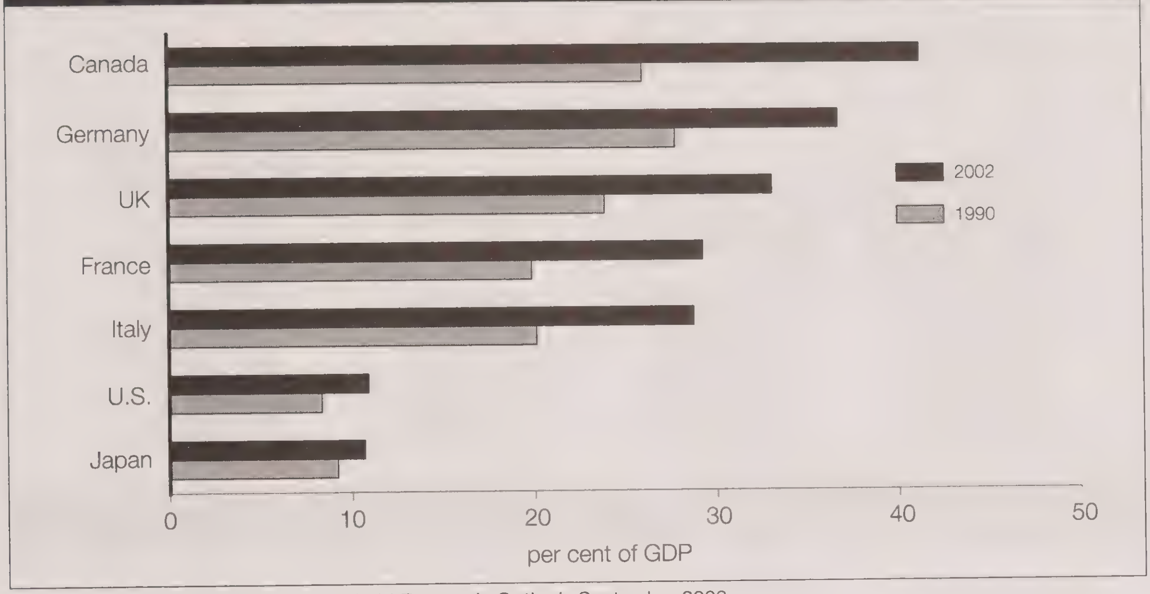


Source: OECD, *Main Science and Technology Indicators* (2003-1).

- Supported by a stronger foundation for growth and government support for research and development, the growth rate of real R&D investment has improved since 1997.
- Overall, real R&D expenditures have grown from $12.0 billion in 1997 to $15.9 billion in 2002. The number of full-time equivalent R&D researchers also increased to more than 90,000 in 1999 from fewer than 70,000 in the early 1990s.
- Furthermore, a growing proportion of R&D is now performed by the business sector and universities. Business enterprises also made the largest contribution to the growth in the number of R&D researchers over the past two decades.
- Increased R&D spending is generating innovative new products, services and technologies and providing Canadians with leading-edge skills.

Canada has become the most open economy in the G-7

Exports of Goods and Services in G-7 Countries

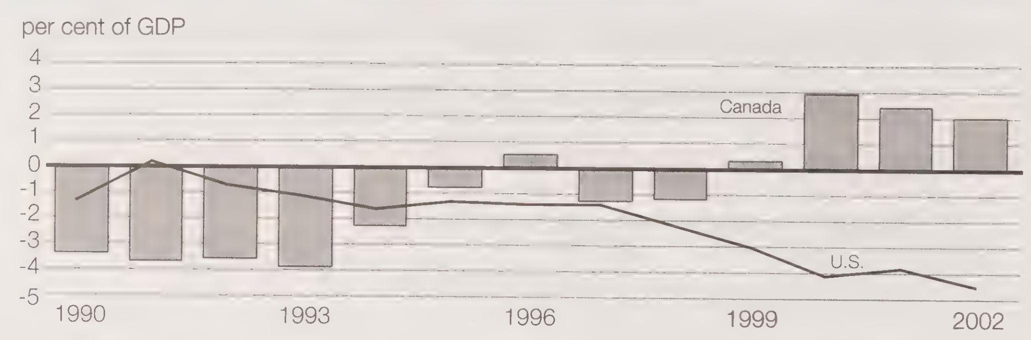


Source: International Monetary Fund, *World Economic Outlook*, September 2003.

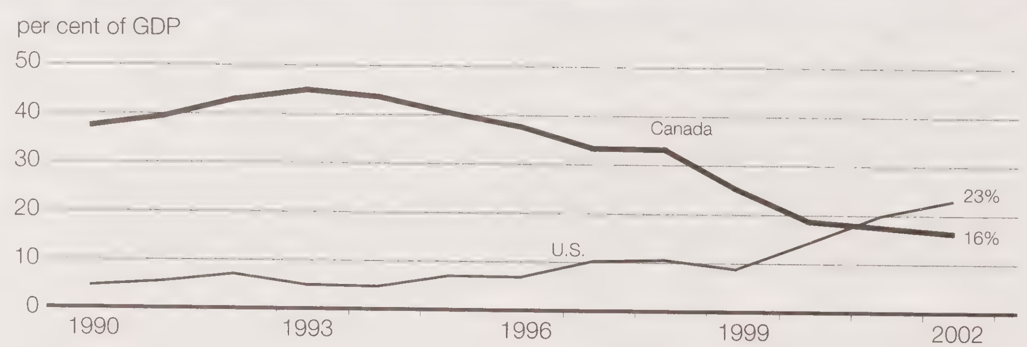
- Between 1990 and 2002 Canada's exposure to foreign trade increased more than any other G-7 country. Indeed, as a share of the economy, Canada exported more than 40 per cent of its goods and services in 2002, making it the most open of all G-7 economies.
- Canada has a long history of successfully embracing global markets. In 1989 Canada signed the Canada–U.S. Free Trade Agreement with the United States.
- In 1994 the Canada–U.S. Free Trade Agreement was expanded to include Mexico, creating the North American Free Trade Agreement.
- Since the implementation of the Canada–U.S. Free Trade Agreement, Canadian exports to the U.S. as a share of GDP have increased from 19.1 per cent in 1988 to 33.1 per cent in 2002.
- This expansion of trade has not only promoted employment and growth, but has also increased Canadians' access to products from around the world and improved the allocation of resources, which in turn has contributed to progress in improving growth in productivity and living standards.

Canada's increased economic competitiveness and improved fiscal position have contributed to a current account surplus and a sharp reduction in net foreign debt

Current Account Balance



Net Foreign Debt



Note: U.S. net foreign debt for 2002 is an estimate.

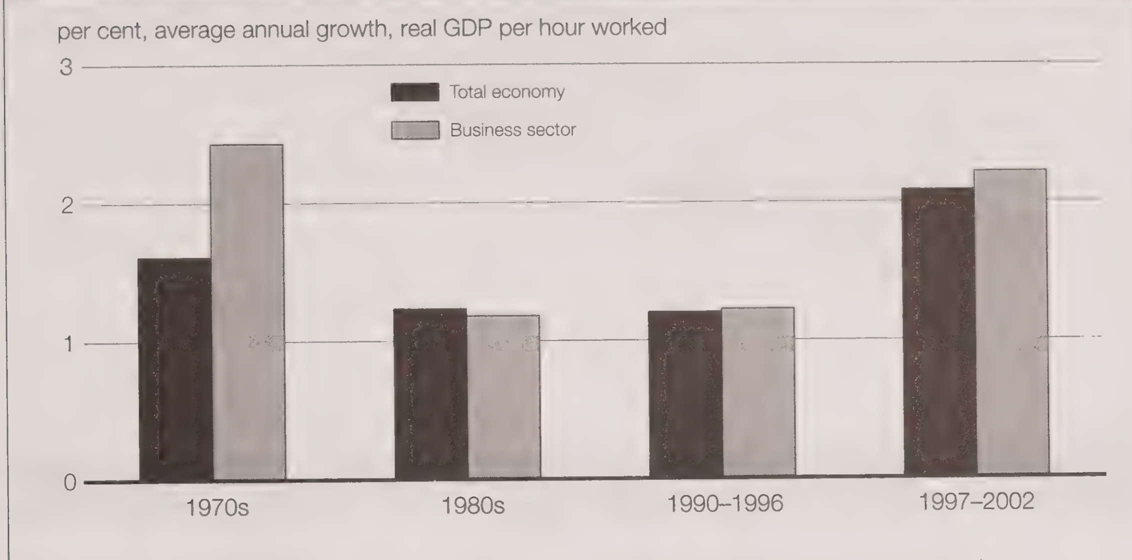
Sources: Statistics Canada and Bureau of Economic Analysis.

- Canada's improved business competitiveness in recent years can also be seen in our current account balance, which has gone from large deficits through the 1980s and most of the 1990s to large surpluses today, despite the U.S. economic slowdown.
- As a result, Canada's net foreign debt[1] as a per cent of GDP fell from 44 per cent in the early 1990s to 16 per cent in 2002—the lowest level in more than 50 years. This means that more of the income that Canadians earn is staying in Canada.
- Canada's net foreign debt is now below that of the U.S. for the first time ever. With continuing budgetary and current account surpluses expected in Canada, and continuing deficits anticipated in the U.S., Canada's net foreign indebtedness should continue to fall and the gap vis-à-vis the U.S. continue to widen.

[1] Net foreign debt is the sum of all financial liabilities to foreigners of Canadian firms, governments and households, net of all foreign assets of Canadian firms, governments and households.

Improved fundamentals have supported a more productive economy...

Labour Productivity Growth

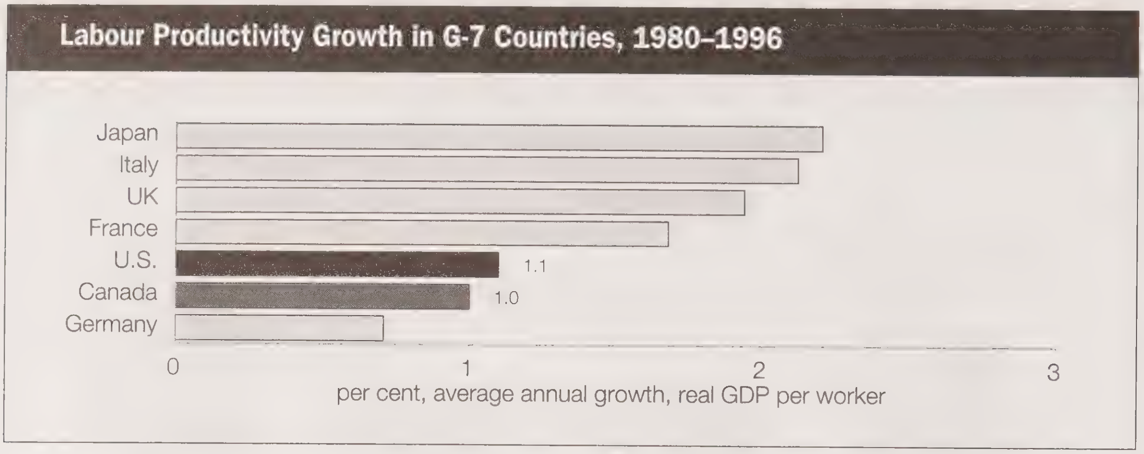


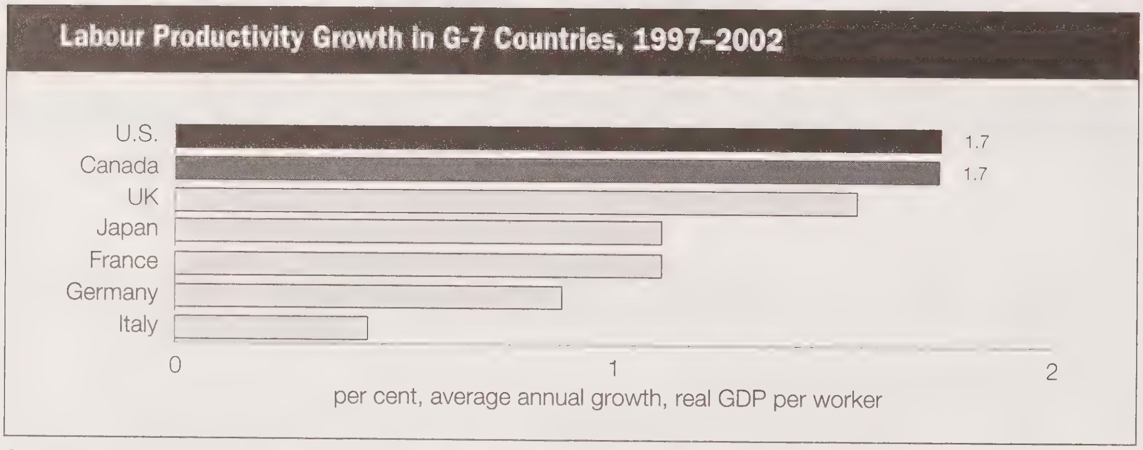
Sources: Statistics Canada and Department of Finance calculations.

- Fiscal and monetary credibility, the embracing of global markets by Canadian business and improved investment have contributed to a rebound in labour productivity growth since 1997.

- Labour productivity growth in Canada, particularly in the business sector, had slowed markedly in the 20 years following the mid-1970s. Measured as real GDP per hour worked, labour productivity growth in the Canadian economy rose from an average of 1.2 per cent per year over the 1990 to 1996 period to 2.1 per cent per year over the 1997 to 2002 period, surpassing the rate recorded during the 1970s.

...making Canada a leader in productivity growth





Sources: *OECD Economic Outlook*, No. 73 (June 2003), Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics.

- The sharp improvement in labour productivity growth in the late 1990s has made Canada a G-7 leader in this area over the last six years. Over the 1997 to 2002 period Canada's growth in real GDP per worker was the same as in the U.S.—a sharp improvement from the 1980 to 1996 period.
- However, a sizeable gap still exists between the level of productivity performance in Canada and the U.S. In 2002 real GDP per worker in Canada is estimated at 78.2 per cent of the U.S. level.[1]

[1] Measured in 2002 U.S. dollars using OECD multilateral purchasing power parity.

Most of the improvement in productivity growth over the late 1990s occurred in ICT-intensive industries

Labour Productivity Growth in Canada by ICT Intensity

	1990–1996	1997–2000	Change
	(per cent, average annual growth)		
Private sector[1]	1.1	1.7	0.6
ICT-intensive industries	1.9	3.2	1.3
Non-ICT-intensive industries	0.5	0.5	0.0
of which:			
Manufacturing	2.7	1.8	-0.9
ICT-intensive industries	4.7	8.6	3.9
Non-ICT-intensive industries	2.6	1.1	-1.5
Services	0.7	1.6	0.9
ICT-intensive industries	1.7	3.0	1.3
Non-ICT-intensive industries	-0.5	-0.7	-0.2

Note: Labour productivity here is measured as real GDP at basic prices per worker.
Intensive users of ICT include ICT manufacturing (computer and electronic products), business services (professional, scientific, technical and administrative services), information services, wholesale trade, retail trade, finance, insurance and real estate.

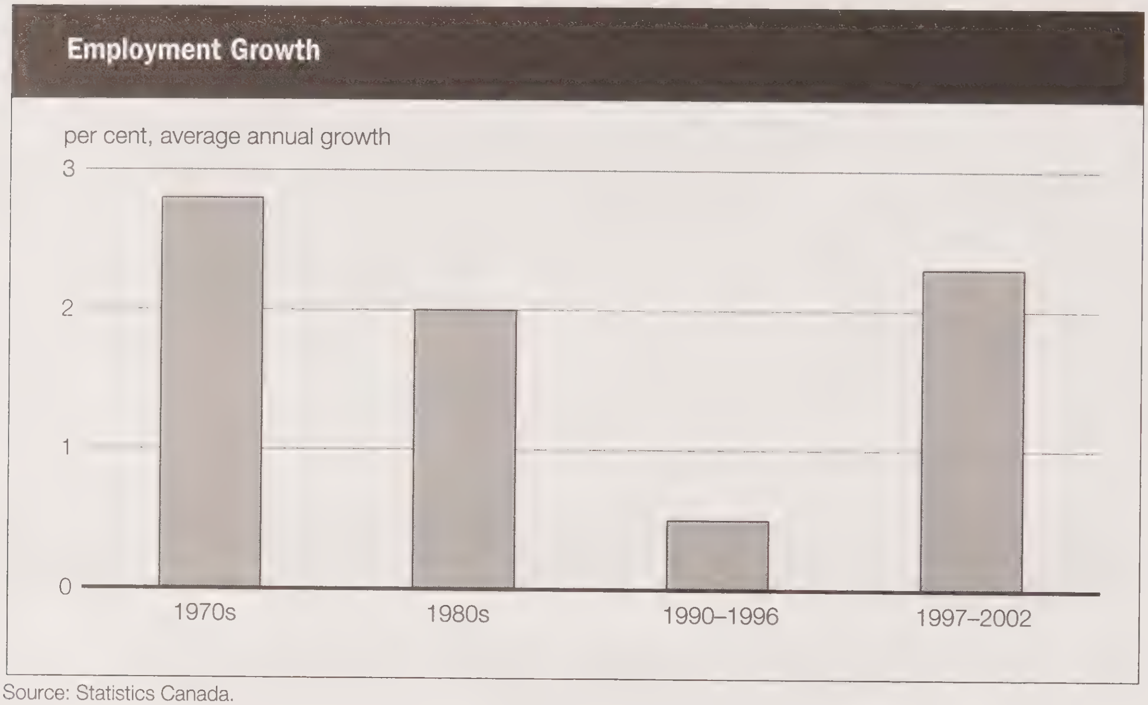
[1] Total economy minus public administration.

Sources: Statistics Canada and Department of Finance calculations.

- The increase in productivity growth in Canada appears to have been focused primarily in industries that intensively use information and communications technologies. This is true in both the manufacturing and services sectors of the economy.

- In fact, within the private sector, only ICT-intensive industries experienced a pickup in labour productivity growth over the 1997 to 2000 period.

Increased productivity growth has gone hand-in-hand with faster job creation...



Source: Statistics Canada.

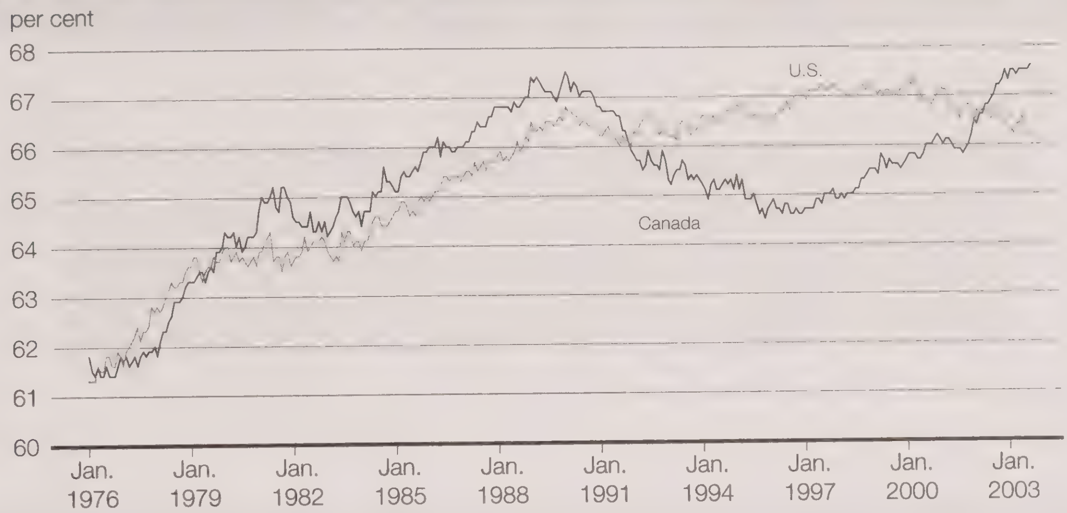
- Along with business investment and productivity growth, job creation slowed during the 20 years following the mid-1970s. In particular, Canada experienced a more severe decline in employment than the U.S. during the recessions of the early 1980s and early 1990s.

- However, with the recovery in investment and productivity, employment growth has rebounded strongly since 1997, reflecting improved economic and policy fundamentals. Following average growth of 0.5 per cent per year over the 1990 to 1996 period, employment increased by 2.3 per cent per year on average over the 1997 to 2002 period, exceeding the growth rates in other G-7 economies. Today there are 3 million more people working in Canada than in 1993.

- Most of the newly created jobs were full time, with job gains in most sectors of the economy and in all regions of Canada. All age groups benefited from the strong growth in job creation, including youths and adults over the age of 55—two groups that often face difficulties finding employment.

...with the Canadian participation rate moving above that in the U.S.

Participation Rate

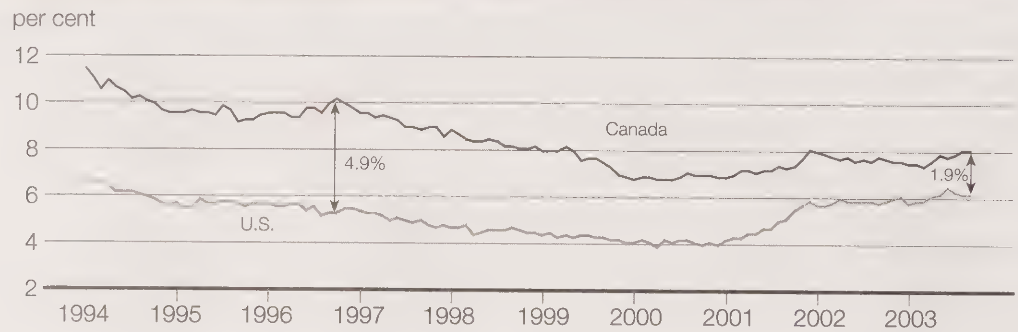


Source: Statistics Canada.

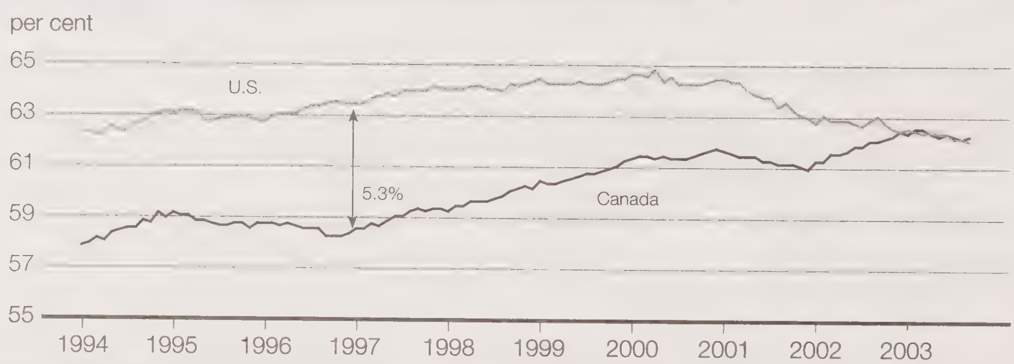
- Healthy job growth has increased Canadians' confidence regarding labour market prospects, leading to a strong rise in the share of the working-age population that is either working or actively looking for work—the participation rate—since 1997.
- In September 2003 the Canadian participation rate reached 67.6 per cent, up substantially from a low of 64.5 per cent in 1996, and has surpassed that of the U.S. since the middle of 2002.
- The rebound in employment growth and in the participation rate since 1997 was especially evident among youths and older workers—the two groups particularly hard hit by the economic weakness of the early 1990s.

Despite the large increase in the participation rate, the unemployment rate has fallen, narrowing Canada's unemployment rate gap with the U.S.

Unemployment Rate



Employment Rate



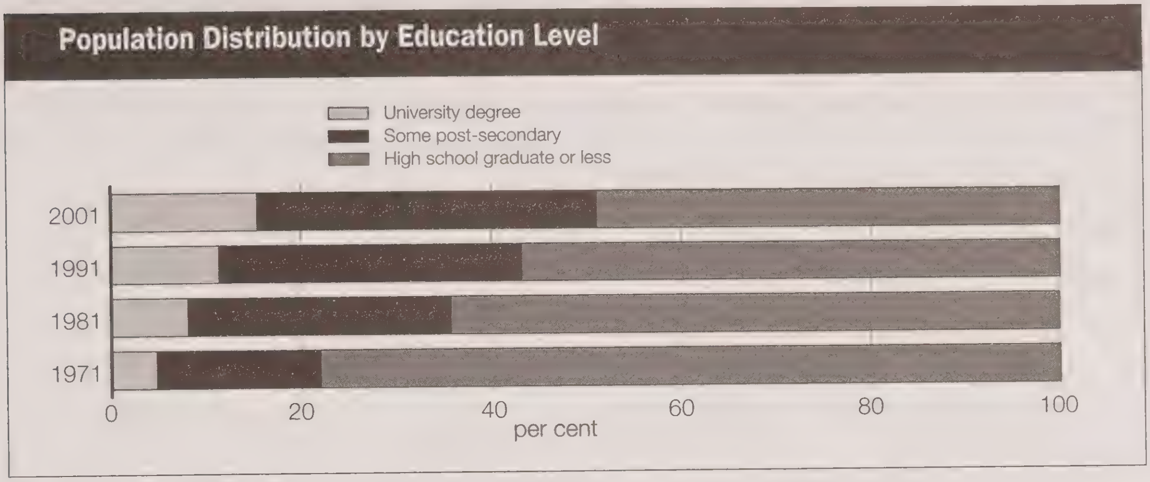
Sources: Statistics Canada and Bureau of Labor Statistics.

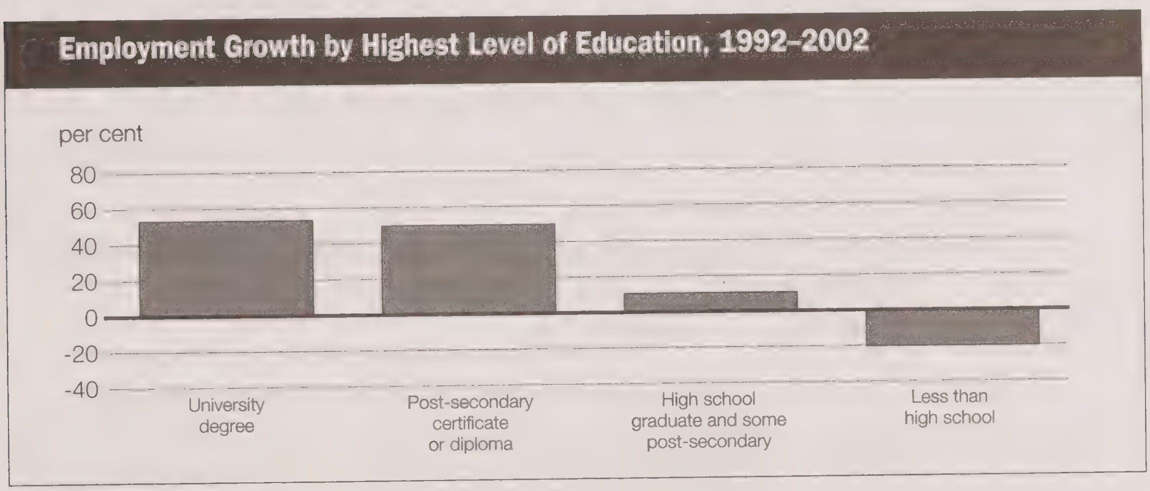
- Despite a strong rise in the participation rate, the Canadian unemployment rate fell from nearly 10 per cent in late 1996 to 8 per cent in September 2003, narrowing the Canada–U.S. unemployment rate gap from close to 5 percentage points to about 2 percentage points. If the Canadian unemployment rate were measured according to the U.S. definition, the gap would be 1.1 percentage points.

- Strong employment gains in Canada have raised the proportion of the working-age population holding a job—the employment rate—since 1997, bringing it to a level similar to that in the U.S. for the first time since 1982.

- A healthy labour market since 1997 has generated strong income gains, bolstered consumer confidence and supported domestic demand in Canada.

Canadians are becoming more skilled, supporting an increasingly knowledge-intensive economy





Source: Statistics Canada.

- Technology use, innovation and human capital are all interconnected. A knowledge-based economy requires a well-educated and skilled workforce able to make the most of a changing economic environment.

- The share of the population with university or college education has increased markedly. Reflecting the rapid shift towards more knowledge-intensive jobs in all sectors of the economy, most of the new job openings in the 1990s were concentrated in sectors requiring a post-secondary degree or diploma, such as health, natural and applied sciences, social sciences, business and finance. In contrast, job opportunities have deteriorated for those with less than a high school diploma.

The Government has made new investments to help Canadians acquire new skills at all stages of life...

Skills-Related Initiatives

The Government has invested in a wide range of initiatives to directly support and encourage Canadians in acquiring the skills needed to be successful in the knowledge-based economy, including:

✓ Canada Millennium Scholarships

✓ Canada Graduate Scholarships

✓ Canada Study Grants for students with dependants

✓ Improvements to the Canada Student Loans Program

✓ Increased support for the National Literacy Secretariat

✓ Canada Education Savings Grant and registered education savings plans

✓ Enhanced education tax credit

✓ Tax relief for interest on student loans

✓ Tax-free registered retirement savings plan withdrawals for lifelong learning

- To compete internationally and to provide a better standard of living for its citizens, the Government has invested to make its workforce increasingly well-educated, adaptable and skilled.

- In 1998 it introduced the Canadian Opportunities Strategy to better assist Canadians in accessing knowledge and skills. As part of the Strategy, the Government introduced the Canada Millennium Scholarships and the Canada Education Savings Grant to help students fund their education and to encourage and assist families in saving for their children's higher education.

- Building on the Strategy, the Government has made further investments to encourage the acquisition of skills and learning by Canadians. For example, the education tax credit was extended to better support lifelong learning, while the creation of the Canada Graduate Scholarships and improvements to the Canada Student Loans Program help broaden access to post-secondary education and graduate studies.

...and to support lower-income Canadian families and their children

Social Initiatives

The Government has made significant investments in support of Canadian families and their children, including:

✓ The introduction of the Canada Child Tax Benefit and subsequent enhancements

✓ An investment of $2.2 billion over five years under the Early Childhood Development Agreement to expand early childhood development programs

✓ Additional support to enhance the early childhood development of First Nations children

✓ $900 million over five years to provincial and territorial governments to improve access to quality regulated early child care services

✓ Extended tax assistance for persons with disabilities and their families, including a new Child Disability Benefit

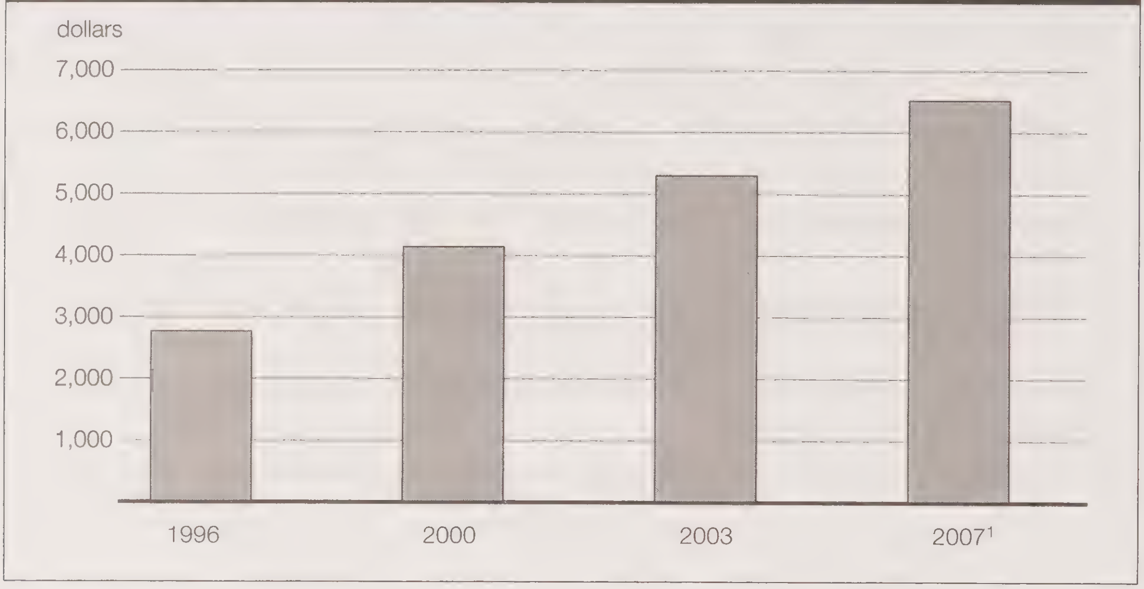
✓ Enhancement of employment insurance maternity and parental benefits

- Only through integrated and complementary economic and social progress will Canada achieve its goal of strong and sustainable living standards growth along with a better quality of life for all Canadians. Since 1997 the Government has invested in measures in support of low- and modest-income families with children to improve the chance that Canadian children will grow up to be healthy, contributing members of society.

- These measures, when combined with strong economic growth and job creation, are essential to reducing poverty and ensuring that families have the resources they need to care for their children.

Income assistance for children in lower-income families ensures that the benefits of economic growth are shared among all Canadians

Maximum Annual Federal Child Benefits
(Family With Two Children—One Child Under Age 7)



[1] Projection.
Source: Department of Finance.

- A balanced budget and renewed economic growth have provided the resources to make new investments in key areas of social policy. The Government has acted to ensure that the benefits of strong economic growth are shared among all Canadians.
- A key element of the Government's agenda has been to combine good social policy with good economic policy. For example, the National Child Benefit (NCB) initiative reduces financial disincentives to leave social assistance by protecting child-related benefits and services when parents leave social assistance to enter the workforce, thereby increasing the rewards from work and reducing child poverty.
- Currently the Canada Child Tax Benefit (CCTB) provides over $8.4 billion in assistance to low- and middle-income families with children. With the enrichments to the NCB supplement announced in the 2003 budget, assistance under the CCTB is projected to reach over $10 billion in 2007, an increase of over 100 per cent since 1996.
- In 1996 the CCTB provided maximum annual benefits of $2,753 for a family with two children, of which one was under 7 years of age. By 2007 maximum annual benefits are projected to increase to $6,511 per family.

New social investment has promoted healthier, vibrant communities

Strong Communities

To help strengthen safe communities and encourage cultural diversity and strong local economies, the Government has made a number of important, strategic investments, including:

✓ Affordable housing agreements with provinces and territories

✓ The National Homelessness Initiative

✓ Housing renovation programs

✓ Infrastructure support, including $3 billion in Budget 2003

✓ Measures to strengthen Aboriginal communities

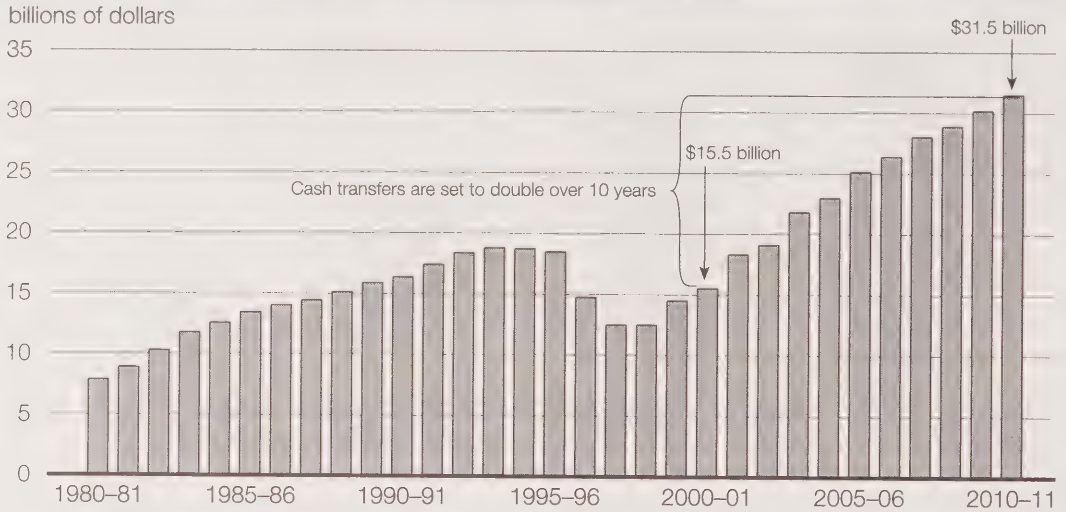
- To improve and sustain economic growth in Canada and to ensure the well-being of Canadians, our cities and communities must be vibrant and competitive.

- All governments must participate in building and strengthening our communities to ensure robust local economies that are well managed, with safe neighbourhoods, modern infrastructure and a productive labour force.

- In support of this objective, the Government has made significant investments to promote healthy communities. For example, in Budgets 2001 and 2003, the Government invested $1 billion on affordable housing over six years to reduce problems of affordability and supply of rental housing, particularly in major urban centres. In Budget 2003 the Government also announced a 10-year $3-billion investment in municipal and strategic infrastructure. This brings the Government's total investment in infrastructure since 1994 to $12 billion. For First Nations on reserves, the Government provides funding for basic services such as education, social services and infrastructure.

The federal government has made significant reinvestments in Canada's health care system through cash transfers to the provinces and territories

Federal Cash Transfers to the Provinces and Territories in Support of Health, Education and Social Programs



Sources: Department of Finance; Canadian Institute for Health Information, *National Health Expenditure Trends, 1975–2002.*

- Canada's publicly funded health care system plays an important role in building the society Canadians value. It is vital to our quality of life and exemplifies complementary economic and social policies. In this context, it helps provide Canada with the distinct economic advantage of a healthy, productive workforce.

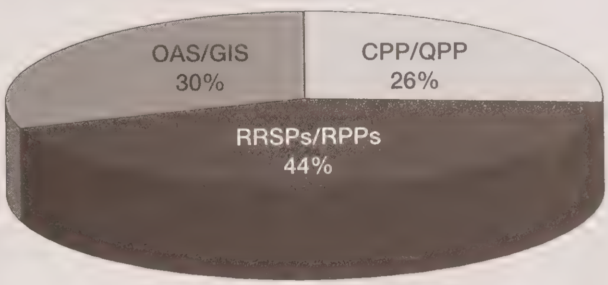
- Transfers to the provinces and territories in support of health and social programs constitute a significant share of federal program spending.

- Since balancing the budget in 1997–98 the federal government has increased funding to the provinces and territories. Cash transfers supporting health and other social services, over $20 billion today, are set to double over 10 years, from $15.5 billion in 2000–01 to $31.5 billion in 2010–11.

- In addition, tax transfers will continue to be an important element of the growing and predictable support provided to the provinces and territories. The tax transfer is approximately $17 billion this year and will continue to grow in line with the economy.

Through sound economic and fiscal management, the "three pillars" of Canada's retirement income system have been placed on a solid footing

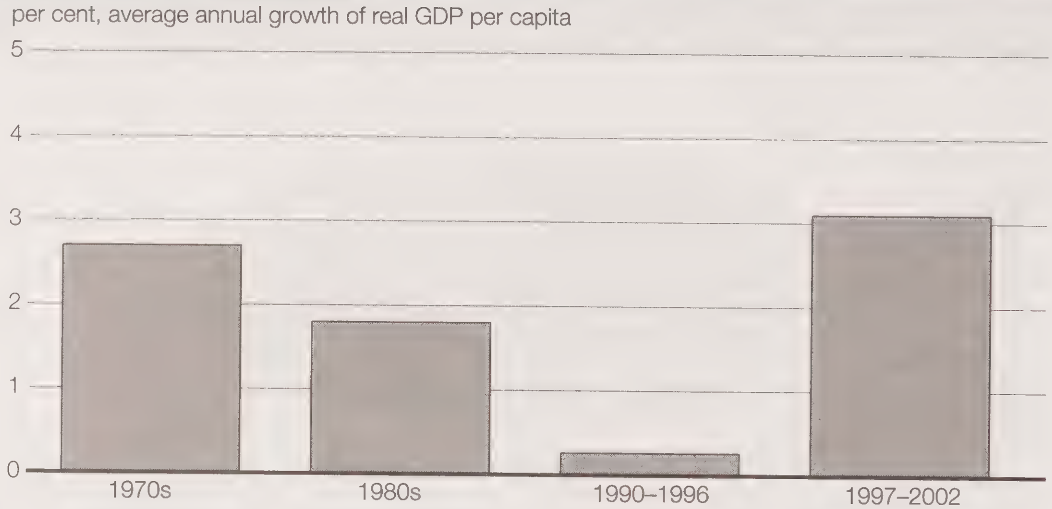
Distribution of Benefits Between Each Pillar of the Retirement Income System, 1999



- Canada's retirement income system is based on three pillars:
  - The federal government-funded Old Age Security and Guaranteed Income Supplement (OAS/GIS) programs provide a basic, minimum guarantee for seniors.
  - The Canada Pension Plan and the Quebec Pension Plan (CPP/QPP), funded through payroll contributions, ensure a basic level of earnings replacement in retirement for all working Canadians.
  - Private tax-assisted retirement savings in registered retirement savings plans (RRSPs) and registered pension plans (RPPs) help and encourage Canadians to save for retirement to supplement their public pensions.
- By balancing the budget and putting the debt-to-GDP ratio on a downward track and through continued prudent budget planning, the Government has ensured the stability of the first pillar of the retirement income system.
- The 1997 CPP/QPP reforms placed the second pillar on a solid financial footing, and it is now actuarially sound for the next 50 years. Canada is one of the very few countries in the world with an actuarially balanced public pension plan.
- Finally, having secured the first two pillars, the Government has moved to strengthen the third pillar by increasing the RPP and RRSP limits and indexing them.

Integrated and complementary economic and social progress has fuelled growth in GDP and living standards

Living Standards Growth



Source: Statistics Canada.

- The result of improved fundamentals—fiscal, monetary and microeconomic—has been renewed strength in GDP growth since the second half of the 1990s.
- During the 1990–1991 recession, Canada was particularly hard hit and recovered far more slowly that the U.S. In contrast, Canada not only avoided the recession that hit the U.S. economy during 2001, but was able to outperform most other countries in the face of global weakness and uncertainty. As a result, Canada led the G-7 in growth in each of the last three years.
- Canada's success in raising productivity and in creating more and better jobs for Canadians has led to a strong rebound in standard of living growth since 1997, which is the goal of Canada's economic policy.
- After slowing through the 1970s and 1980s and having virtually stalled in the early 1990s, real GDP per capita, the widely used measure of living standards, rose by 3.1 per cent per year on average over the 1997 to 2002 period, surpassing the rate observed in the 1970s.
- This means that Canada's real GDP per capita, or standard of living, has increased 20 per cent over the past six years.

Annex 2

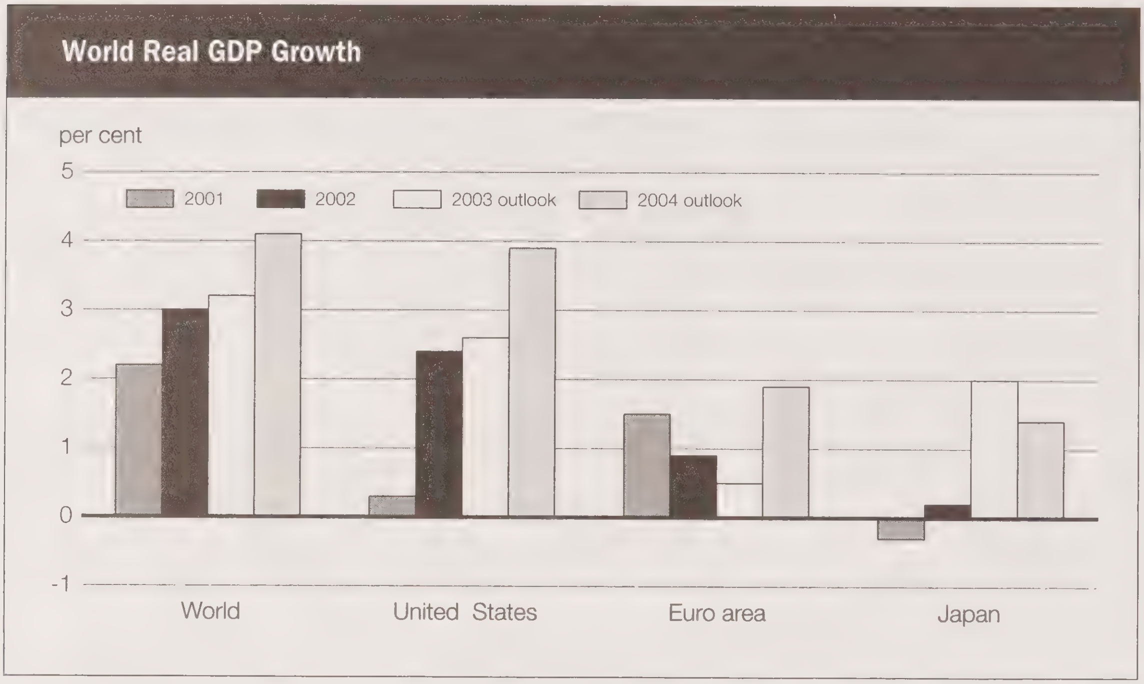
Canada's Recent Economic Developments and Outlook[1]

[1] Incorporates data available up to October 28, 2003.

Highlights

- *The global economic recovery has been uneven in 2003 but is expected to accelerate through the remainder of this year and next year, with the U.S. economy leading the way.*
- *Canadian growth has been dampened this year by severe acute respiratory syndrome (SARS), a single case of mad cow disease, the Ontario electricity blackout, massive forest fires in B.C. and the rapid appreciation of the dollar.*
- *The Canadian labour market has not been immune to these shocks. After a very strong performance in 2002, employment growth slowed in 2003. Nonetheless, a total of 98,200 new jobs have been created since the beginning of this year.*
- *Private sector economists expect stronger U.S. growth and low Canadian interest rates to support a recovery in Canadian growth over the balance of this year and into 2004. For 2003 they now expect real gross domestic product (GDP) growth of 1.9 per cent, down sharply from the 3.2 per cent they forecast at the time of the 2003 budget. They forecast 3-per-cent real growth in 2004, down from the 3.5 per cent forecast in the 2003 budget.*
- *Private sector economists believe that the extent and the speed of the appreciation of the Canadian dollar, as well as the uncertainty about future levels of the dollar, represent downside risks to their short-term Canadian growth forecast.*

The global economic recovery has been uneven but is expected to pick up speed in the second half of this year and next year...



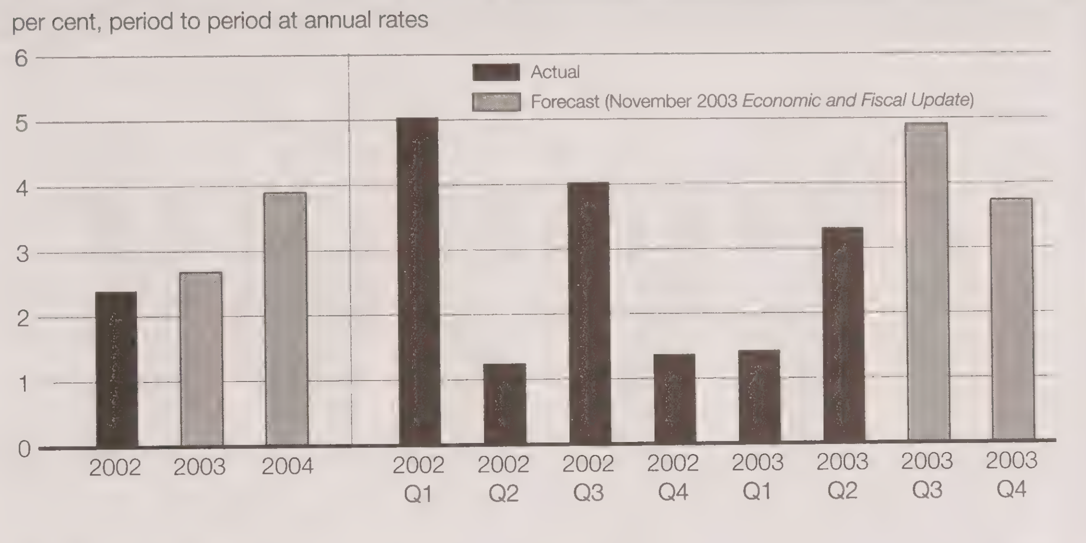
Source: International Monetary Fund, *World Economic Outlook*, September 2003.

- Following the global economic slowdown in 2001, the recovery in the world economy has been relatively modest and uneven. The International Monetary Fund (IMF) is projecting an upturn in global activity in the second half of this year, with real GDP growth for the year averaging 3.2 per cent.

- With reduced geopolitical uncertainties, monetary and fiscal policy stimulus in several countries, and a projected decline in oil prices, global growth is projected to strengthen to 4.1 per cent in 2004, led by the United States and developing and transition economies. The IMF forecasts that euro area growth will be only 1.9 per cent in 2004 and Japanese growth will be even weaker. Indeed, while recent data suggesting a stronger performance have led to a more optimistic outlook for growth in Japan in 2003, ongoing deflation and structural problems, including banking and corporate sector weakness, will continue to constrain domestic demand and real GDP growth in 2004.

...with the U.S. economy leading the way

U.S. Real GDP Growth



Source: *Blue Chip Economic Indicators*, October 2003.

- Following the recession in 2001 U.S. real GDP growth has been uneven. This reflects geopolitical uncertainties preceding the war in Iraq, accounting scandals and the lingering effects of the bursting of the stock market bubble.

- However, monetary and fiscal stimulus and a weaker U.S. dollar have contributed to a strengthening U.S. recovery. The U.S. economy grew a solid 3.3 per cent in the second quarter of 2003 and is estimated to have accelerated much further in the third quarter, aided by a pickup in consumer spending and business investment in equipment and software.

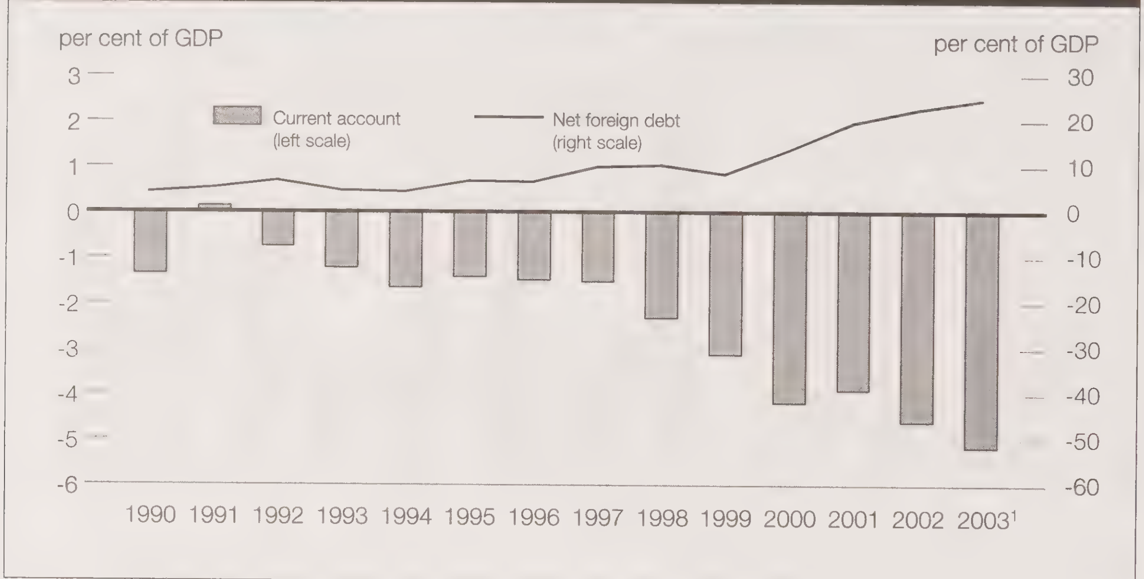
- Accommodative monetary and fiscal policies are expected to continue to support economic activity next year. Private sector forecasters expect growth to average about 4 per cent in 2004.

- The sustainability of the U.S. recovery depends on the economy delivering sustained job growth and a rebound in business investment. If not, consumer demand could weaken and investment could slow as companies lose faith in the durability of the recovery.

- Over the medium term the main risk is the large U.S. fiscal deficit, which, if not corrected, could put upward pressure on interest rates.

But the U.S. economy has been running large current account deficits, which have recently led to a realignment of world currencies

U.S. Current Account Balance and Net Foreign Debt

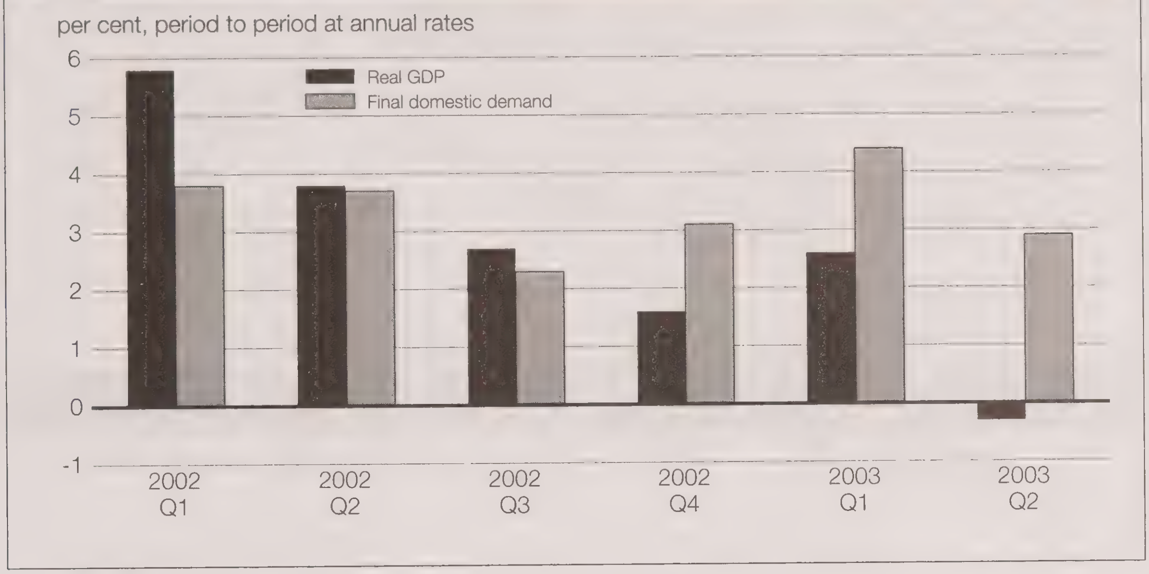


[1] First half of 2003.

- The United States has been running current account deficits for over a decade. Since 2000 the current account deficit has averaged more than 4 per cent of GDP per year.
- This has led to a steady increase in U.S. net foreign debt as a share of GDP, rising from about 5 per cent in 1993 to about 23 per cent in 2002.
- The depreciation of the U.S. dollar against a broad array of currencies in 2002 and 2003 is a key factor in the adjustment process required to correct global imbalances. Since the beginning of 2002 the U.S. dollar has fallen by more than 10 per cent against a broad basket of currencies. In particular, it has fallen by about 24 per cent against the euro, 27 per cent against the Australian dollar, 17 per cent against the yen and 18 per cent against the Canadian dollar.

Canadian domestic demand growth has remained healthy; however, a series of shocks contributed to the stalling of GDP growth in the second quarter

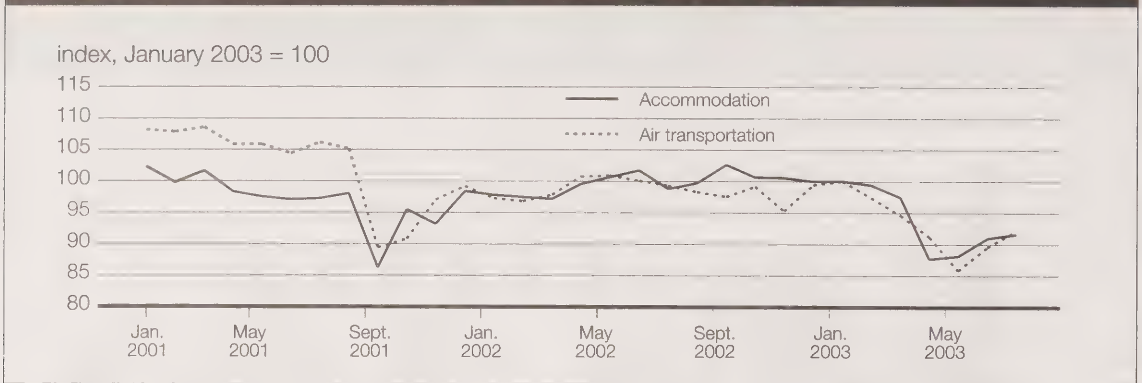
Real GDP and Final Domestic Demand Growth



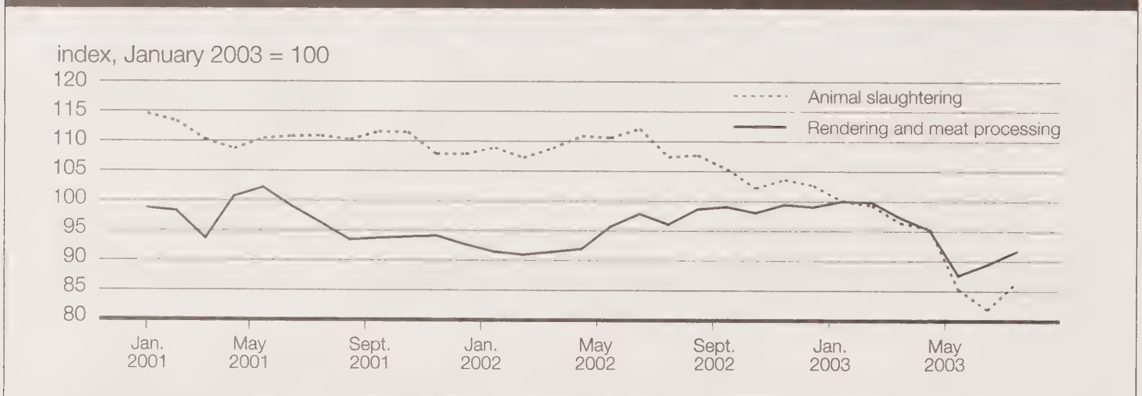
- Although Canadian real GDP growth slowed through 2002 and into 2003, final domestic demand growth remained robust.
- Solid consumer spending and residential investment growth have been important contributing factors to continued domestic demand growth.
- Notwithstanding solid domestic demand, the combined impact of SARS, bovine spongiform encephalopathy (BSE or mad cow disease) and the rapid appreciation of the Canadian dollar contributed to the stalling of real GDP growth in the second quarter of 2003.

The Canadian economy was hit by a number of shocks in the second and third quarters of 2003

Output of Accommodation and Air Transportation Services

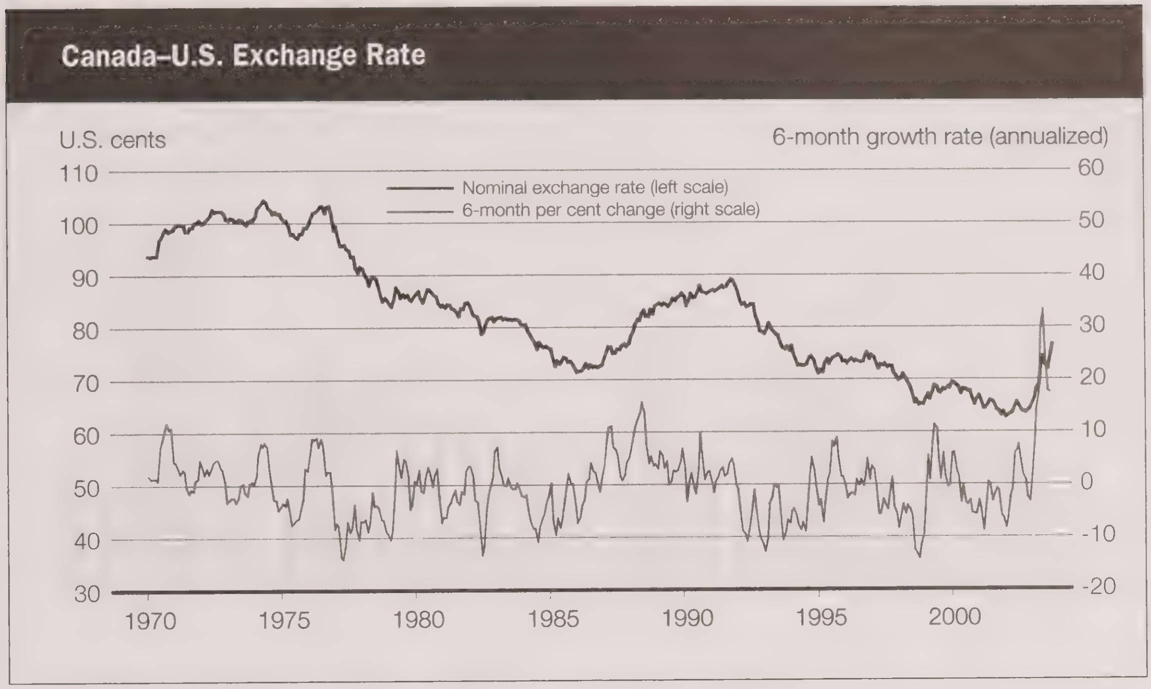


Output of Slaughtering and Meat Processing Industries



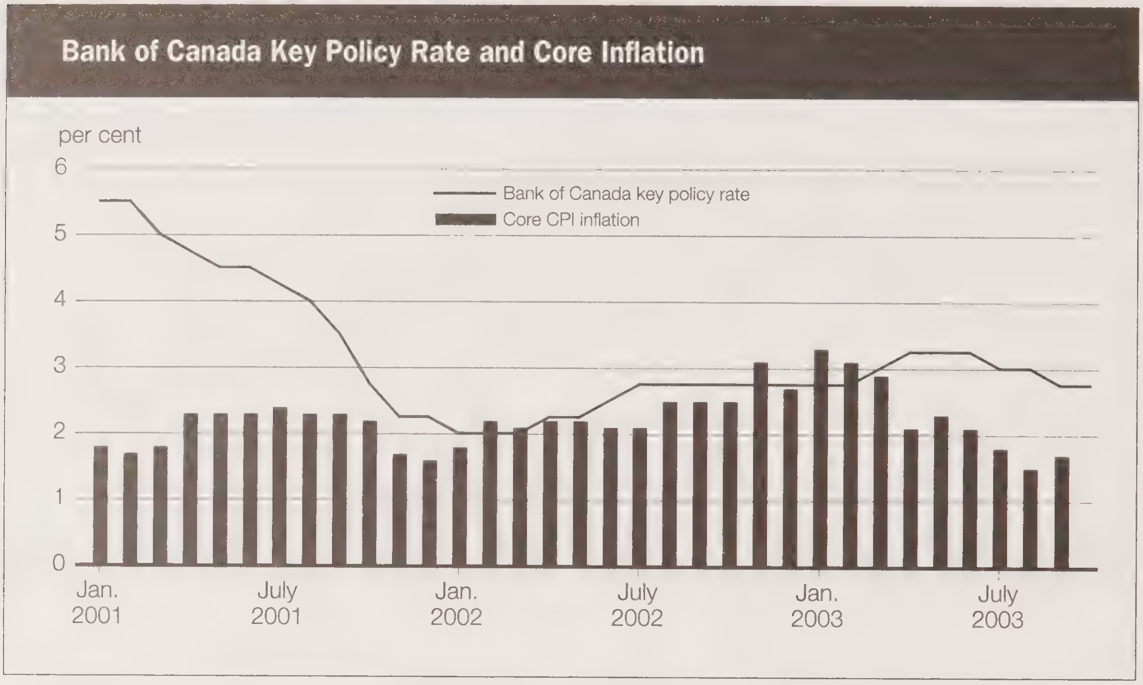
- SARS hit travel-related industries, including accommodation and air transportation services. Real exports of travel services dropped almost 14 per cent (quarterly rate) in the second quarter of 2003 as SARS led to a sharp decline in foreign visitors to Canada.
- The export ban imposed as a result of a single case of BSE led to a 10-per-cent drop in the output of the slaughtering and meat processing industries between April and June.
- The electricity blackout in August in Ontario crippled much of the province's manufacturing sector for several days. The blackout and its lingering impact were significant factors behind a 4.5-per-cent decline in manufacturing shipments and a 5-per-cent decline in real exports in August.
- Massive forest fires in British Columbia affected the lumber industry in the interior of B.C., and Nova Scotia was recently battered by Hurricane Juan.

The Canadian dollar appreciated rapidly this year



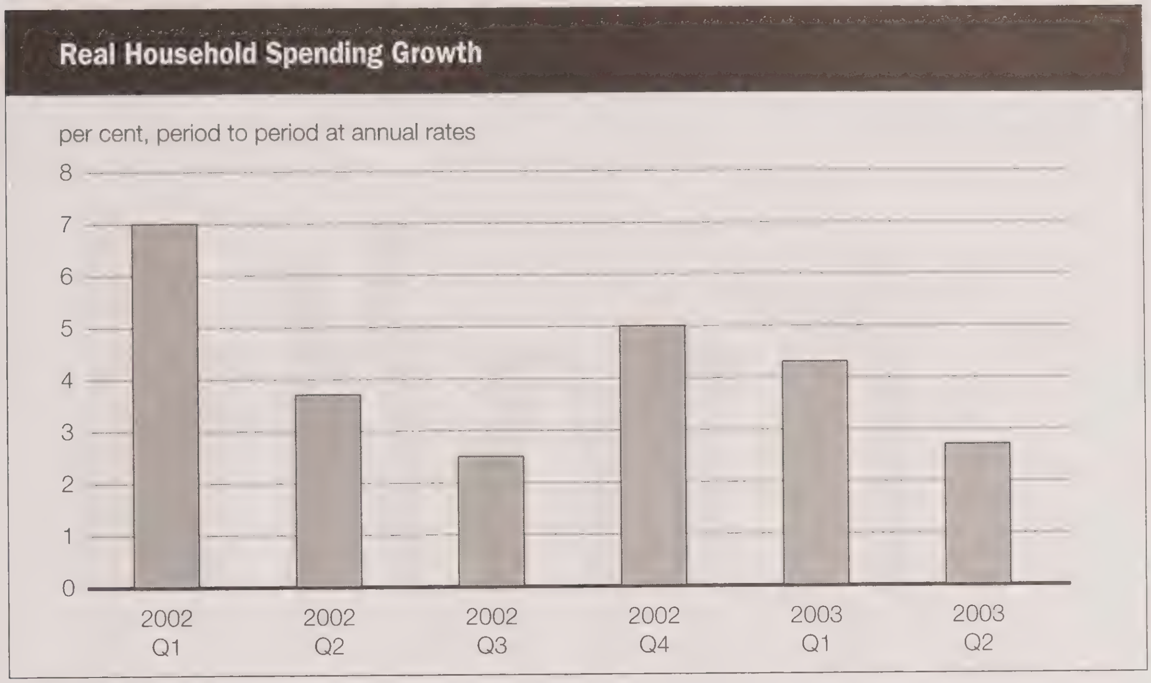
- Another factor impacting growth in the Canadian economy this year and next is the rapid appreciation of the Canadian dollar vis-à-vis the U.S. dollar. The 17-per-cent appreciation of the Canadian dollar in the first half of this year is the largest on record over a six-month period. The Canadian dollar has continued to appreciate and is now about 21 per cent above its level at the beginning of the year.
- The rapid appreciation of the Canadian dollar reflects the general weakness of the U.S. dollar against all major currencies as well as increases in some commodity prices.
- A significant rise in the value of our currency reduces the profits of exporters and lowers foreign demand for Canadian goods and services. It also leads Canadians to substitute cheaper imported goods for domestically produced goods. This means there will be trade balance adjustments in response to this significant appreciation of the Canadian dollar.

Monetary and fiscal policy credibility has enabled the Bank of Canada to respond to shocks as needed



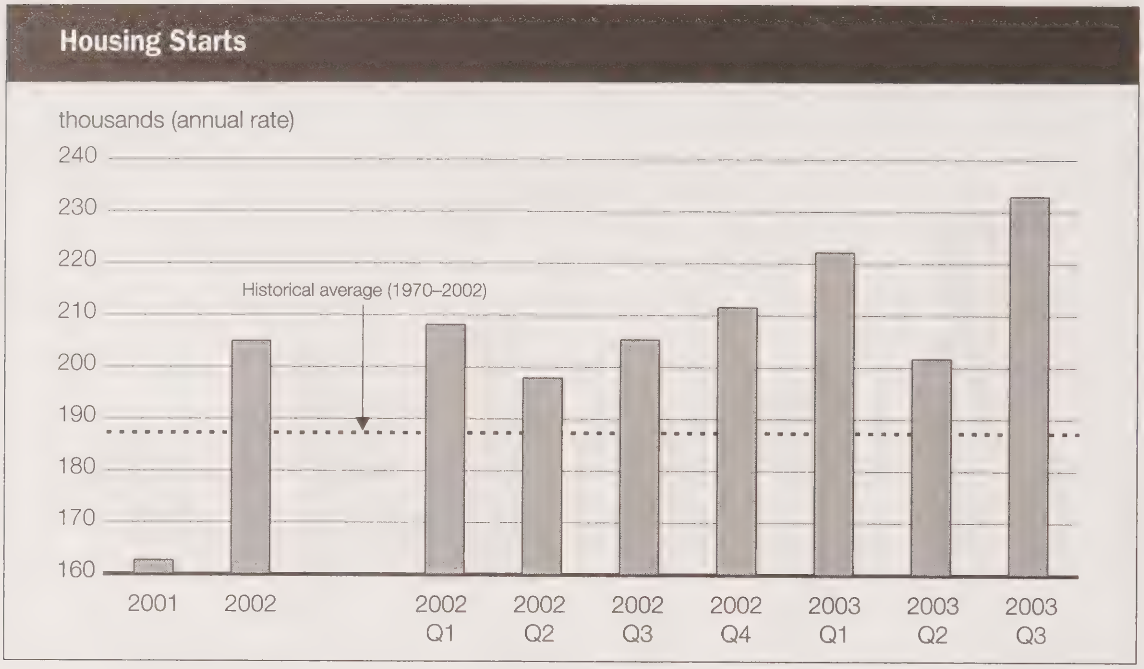
- In the first half of 2003, in response to above-target inflation and concerns about rising inflation expectations, the Bank of Canada increased its key policy rate (the target for the overnight rate) on two occasions by a total of 50 basis points to 3.25 per cent.
- In July and then again in September, the Bank of Canada subsequently lowered its key policy rate back to 2.75 per cent, citing faster-than-expected declines in inflation and inflation expectations, as well as negative effects from SARS, BSE and the appreciation of the Canadian dollar.
- Low interest rates should help offset the impact of recent shocks.

Low interest rates have supported household spending, which has been the main contributor to GDP growth



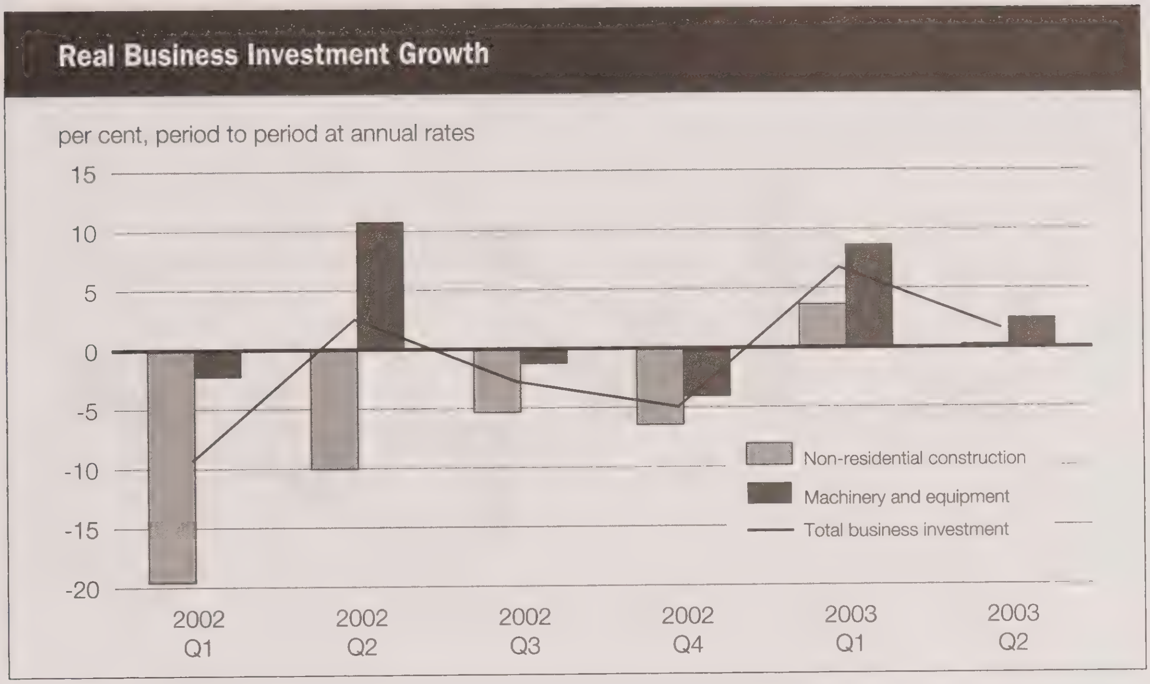
- Supported by historically low interest rates and high consumer confidence, household spending has been the main contributor to GDP growth since the beginning of 2002.
- Over this period real household spending has grown 4.2 per cent on average, reflecting increases in all categories of consumer spending, particularly those that are more sensitive to interest rates.

In particular, housing activity has been a major driver of Canadian domestic demand growth



- A key element of healthy household spending growth has been sustained growth in residential investment.
- Residential investment in the second quarter of 2003 was 8 per cent higher than a year earlier. Housing starts and renovation expenditures have both contributed to the strength in residential investment. At the current pace of 219,000 new units for 2003, housing starts are at their highest level since 1988.
- Improved housing affordability, reflecting low mortgage rates and rising incomes, has contributed to strong housing demand.

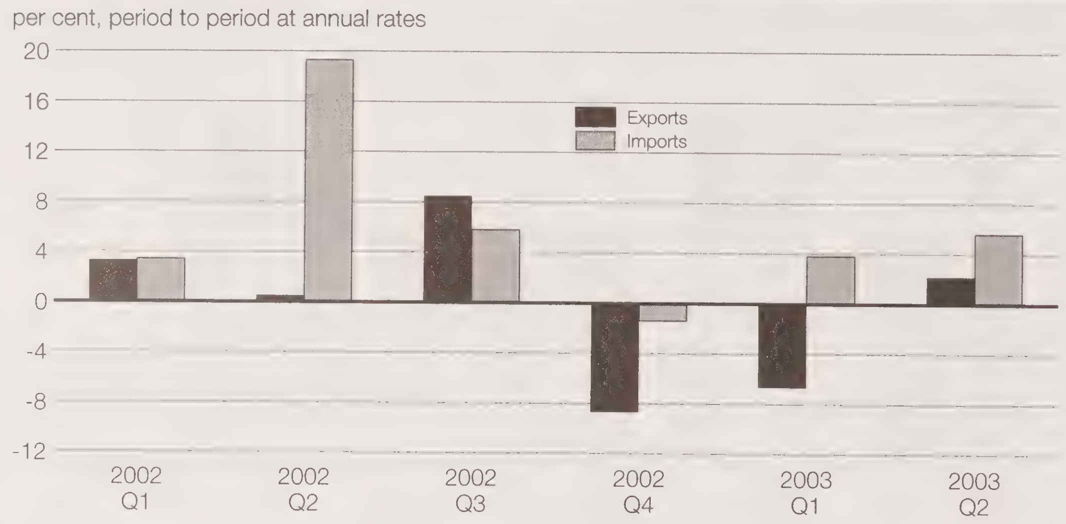
Business investment is gradually recovering



- Business investment declined in 2002. After this negative growth last year, both machinery and equipment and non-residential construction showed positive growth in the first half of 2003.
- Healthy corporate profits, low interest rates, a strengthening external environment and sustained gains in the stock market should support healthy investment growth in the coming quarters.
- Indeed, according to the revised 2003 survey of private and public investment intentions released by Statistics Canada in July, total investment is expected to increase by 4 per cent in 2003.

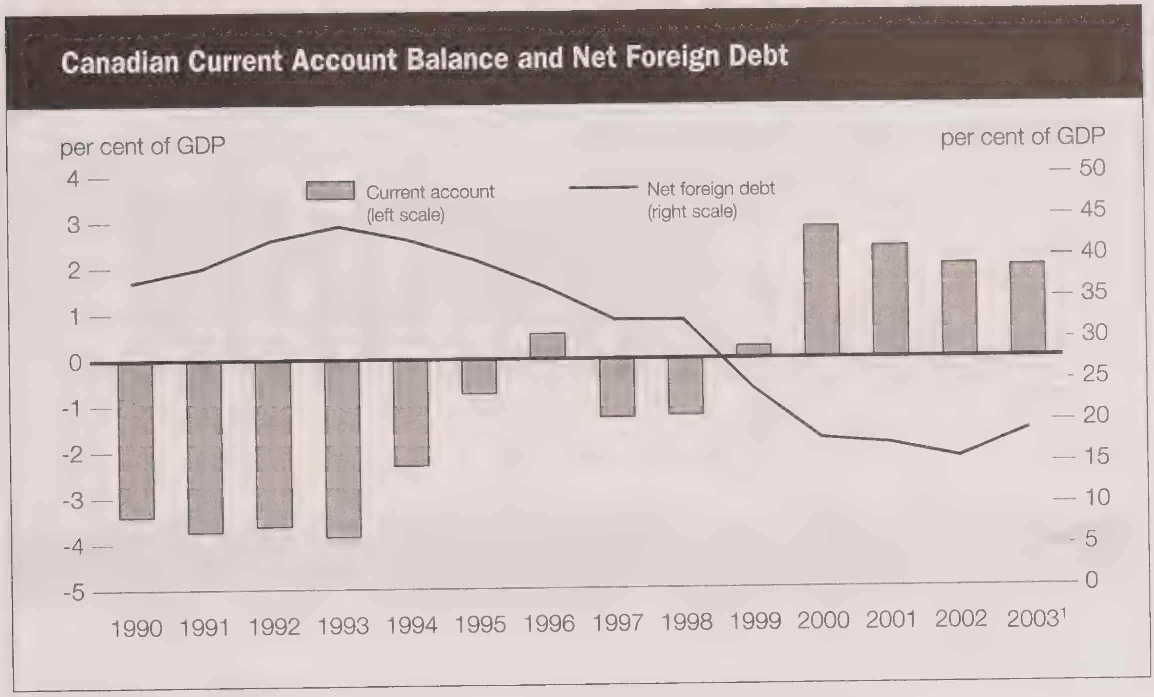
Stronger U.S. growth is supporting Canadian exports in the face of the dampening effect of the Canadian dollar appreciation

Growth in Real Exports and Real Imports



- Real exports fell in the fourth quarter of 2002 and first quarter of 2003, reflecting weaker U.S. demand, partly driven by Iraq-related uncertainties that led U.S. businesses to adopt a wait-and-see approach to the potential conflict.
- Although a stronger U.S. economy boosted exports in the second quarter, merchandise exports weakened over the summer. The strong appreciation of the Canadian dollar and the blackout in August were likely key factors.
- Since the beginning of 2003 real import growth has averaged 4.7 per cent, reflecting strong domestic demand in Canada and a possible shift from domestically produced goods to imported goods in response to a stronger dollar.

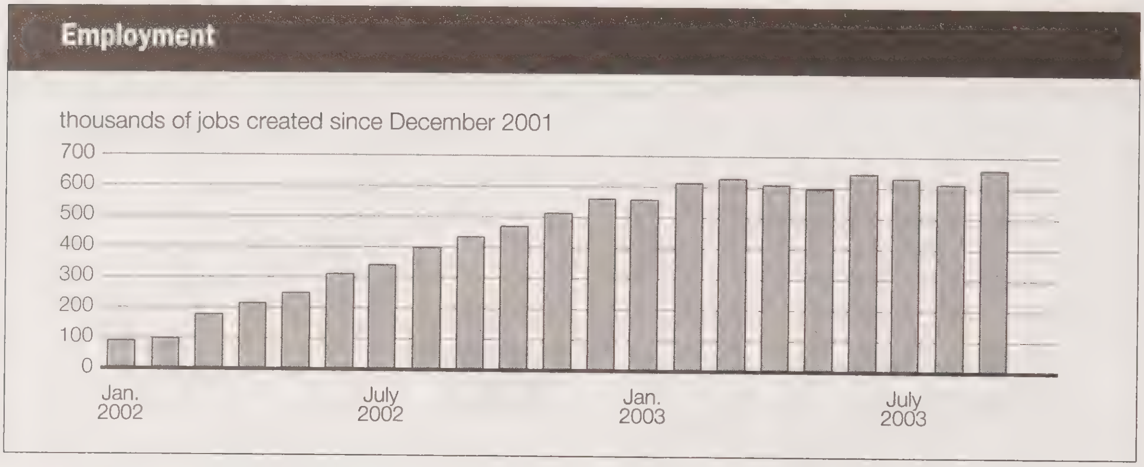
Despite global weakness, Canada's current account remains in surplus and its net foreign debt has declined

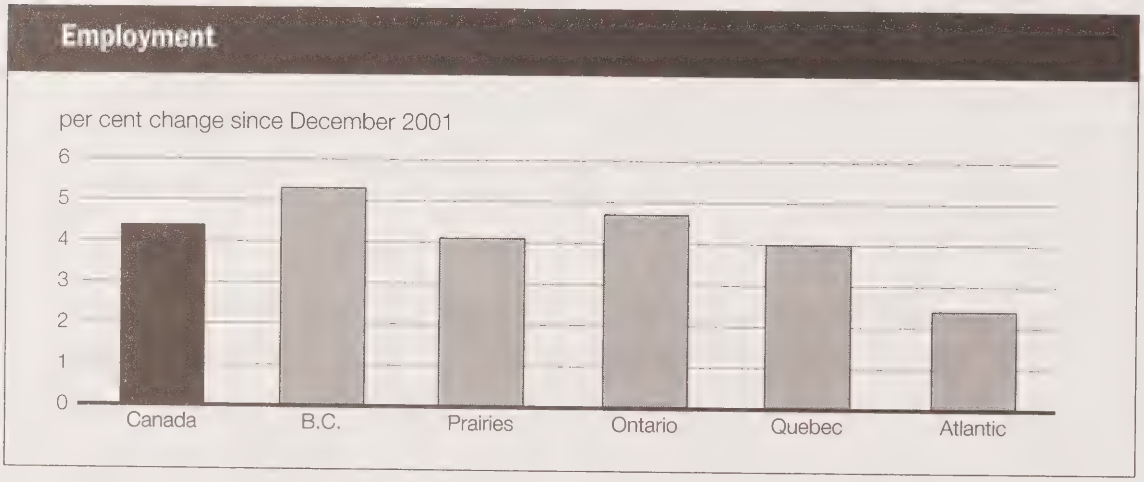


[1] First half of 2003.

- Despite weakness in external demand over the past two years, Canada's current account balance has remained positive.
- In fact, Canada's current account has now been in surplus for 16 consecutive quarters, averaging over 2 per cent of GDP.
- As a result, Canada's net foreign debt as a share of GDP has continued to decline in recent years. Indeed, Canada's foreign debt ratio was 19 per cent in the first half of this year, close to its lowest level in 50 years.
- The decline in net foreign debt means that more of the income that Canadians earn is staying in Canada.
- These developments stand in sharp contrast to the U.S., whose current account and net foreign debt positions have both deteriorated.

After a very strong performance in 2002, employment growth in Canada slowed this year as shocks hit the economy

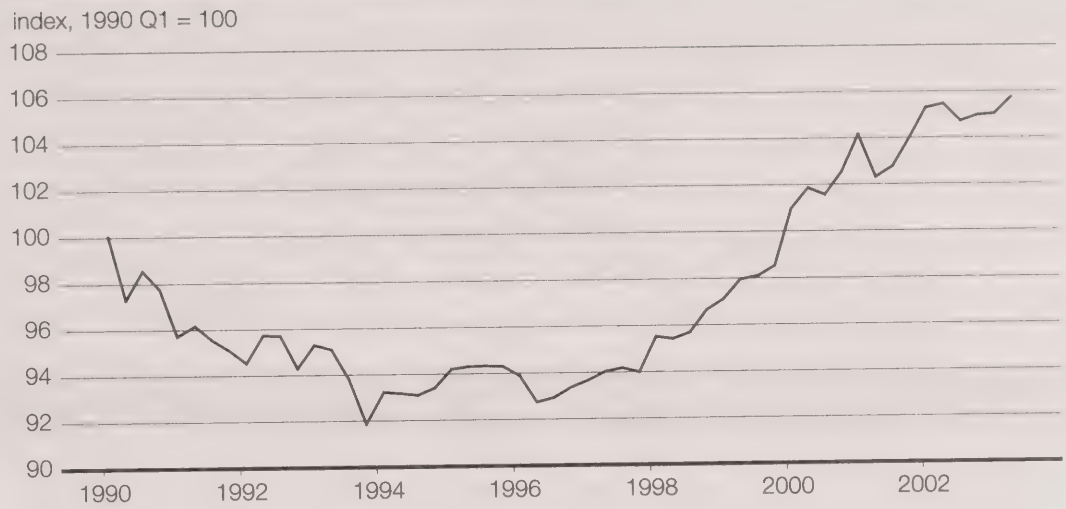




- In 2002 the Canadian economy created 560,200 jobs. This strong labour market performance was an important contributor to domestic demand.
- However, the Canadian labour market has not been immune to recent shocks to the Canadian economy. As a result, job gains have been uneven so far in 2003. A total of 98,200 new jobs have been created since the beginning of the year.
- Slower job creation, combined with participation rates that have remained at record high levels, has caused the unemployment rate to rise to 8 per cent in recent months.
- Although less robust than in 2002, the Canadian labour market continues to show strength relative to the U.S. labour market. In contrast with Canada's job gains, the U.S. economy has lost 336,000 jobs since the beginning of this year.

Employment gains have been reflected in the continued growth of real disposable income of Canadians

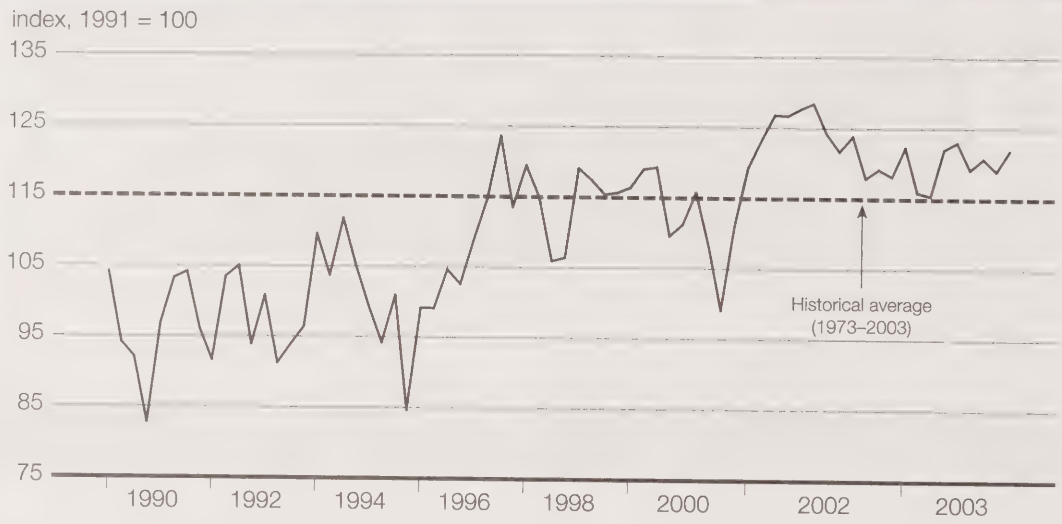
Real Personal Disposable Income per Capita



- Since 1996 real personal disposable income per capita has increased 13 per cent.
- This progress has continued since the beginning of 2001 despite a U.S. recession and subsequent uneven recovery, and shocks to the Canadian economy. The positive performance of recent years in the midst of global economic uncertainty reflects the resilience of the Canadian economy.

In spite of a recent series of shocks, consumer confidence remains historically high

Consumer Confidence



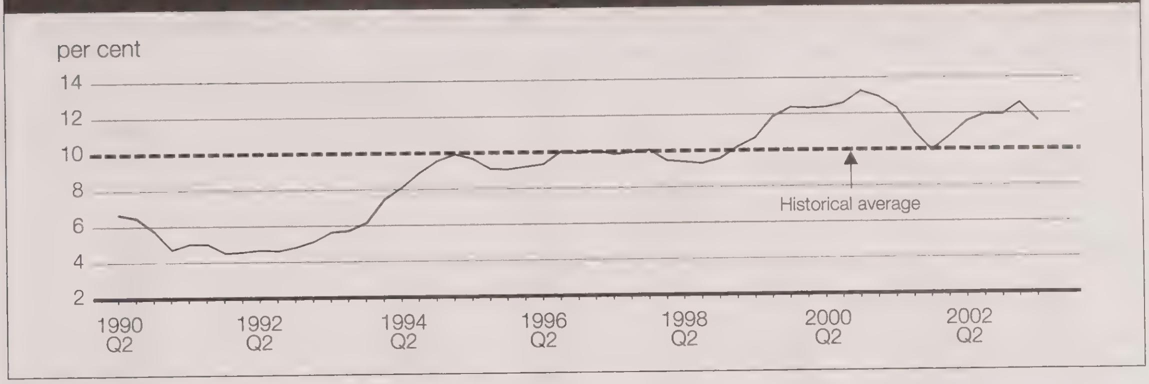
Note: Data are quarterly until September 2002, monthly afterwards.
Source: Conference Board of Canada.

- Strong economic and policy fundamentals and low interest rates, which have helped to keep employment levels high and incomes rising, contributed to keeping consumer confidence relatively steady despite recent shocks to the Canadian economy.

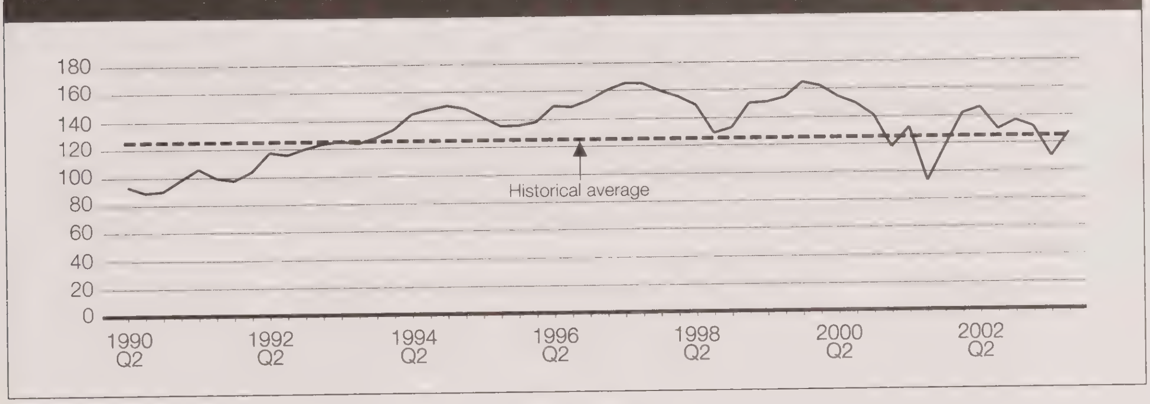
- Consumer confidence in Canada, although lower than its very robust values in the summer of 2002, remains high by historical standards. This should help to underpin the expected strengthening in economic activity in the remainder of this year and into next year.

Corporate profits also remain at a historically high level, boding well for investment

Corporate Profits as a Share of GDP



Conference Board of Canada's Index of Business Confidence



- Despite a slight decline in the second quarter of 2003, corporate profit levels remain quite healthy in Canada. Combined with economic recoveries in both Canada and the U.S., the current level of corporate profits bodes well for future investment growth in Canada.
- Reflecting this, the Conference Board of Canada's Index of Business Confidence rebounded strongly in the third quarter of 2003, with a large increase in the proportion of firms expecting economic conditions to improve in the next six months.
- The latest survey by the Canadian Federation of Independent Business also found that confidence among its members has recovered most of the ground lost earlier this year in the wake of the multiple shocks that hit the Canadian economy. Furthermore, the survey indicated that its members were more positive than a few months ago about what they expected over the next 12 months.

Low borrowing costs should continue to support economic activity in Canada

One-Year Mortgage Rate and Prime Business Rate

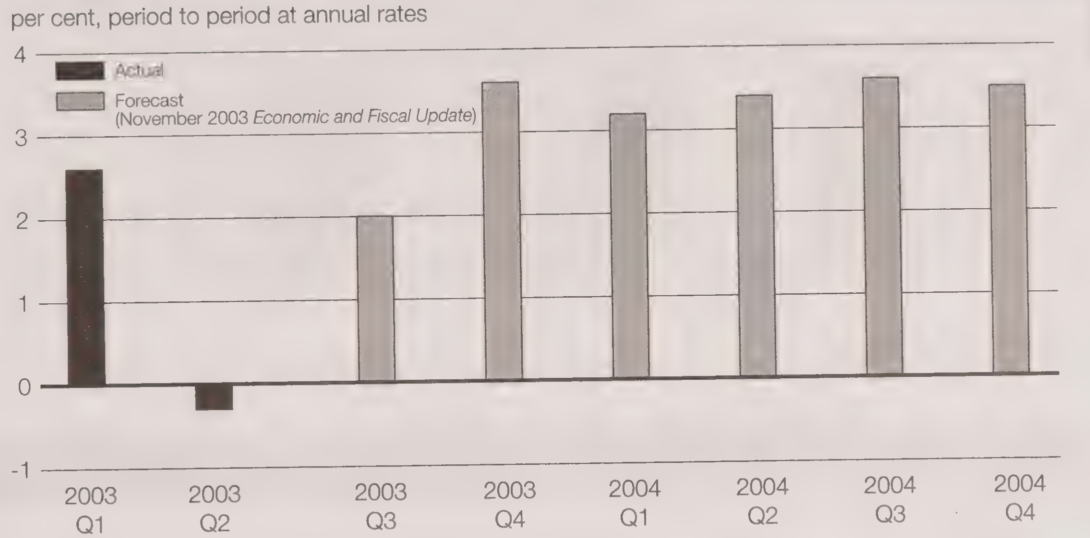
Savings on interest payments since January 2001 on a one-year $100,000 mortgage and a $250,000 business loan

	One-year mortgage rate	Prime business rate
Rate—January 2001	7.70	7.50
Rate—October 22, 2003	4.55	4.50
Change in rate	**-3.15**	**-3.00**
Monthly payment—January 2001	$744.16	$1,562.50
Monthly payment—October 22, 2003	$556.26	$937.50
Change in monthly payment	-$187.90	-$625.00
Change in annual payment	**-$2,254.80**	**-$7,500.00**

- Interest rates remain near historically low levels, providing strong support for household spending and business investment.
- The one-year mortgage rate and prime business rate are currently 4.55 per cent and 4.50 per cent. These rates are 315 basis points and 300 basis points lower than their levels at the beginning of 2001.
- Households now save about $2,250 per year on a new or renegotiated one-year mortgage of $100,000 relative to what they would have paid at the beginning of 2001.
- For their part, businesses now save $7,500 per year on a $250,000 business loan relative to what they would have paid at the beginning of 2001.

Forecasters expect economic growth in Canada to strengthen through the latter part of this year and into 2004

Canadian Real GDP Growth—Private Sector Forecasters

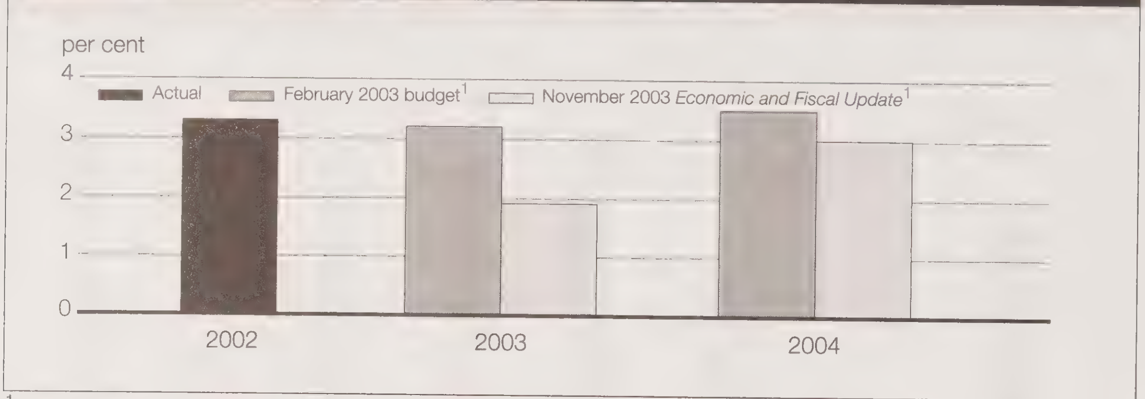


Sources: Statistics Canada; Department of Finance survey of private sector forecasters, September 2003.

- The Department of Finance recently conducted its regular survey of 20 Canadian private sector economists, which is the basis for the five-year status quo fiscal projections provided in Annex 3.
- Taking into account the impacts of the stronger Canadian dollar, SARS, BSE, the blackout and forest fires, private sector economists expect modest GDP growth this year. They expect growth of 2 per cent in the third quarter and about 3½ per cent in the fourth quarter of this year.
- For 2004 the private sector forecasters expect quarterly growth of slightly above 3 per cent. The private sector economists noted that their forecast pace and pattern of growth in 2004 could be impacted by adjustments resulting from the rapid appreciation of the dollar.
- The rebound in growth is supported by continued strong U.S. growth, recent interest rate reductions by the Bank of Canada and a return to more normal levels of output as the negative impacts of recent shocks unwind.

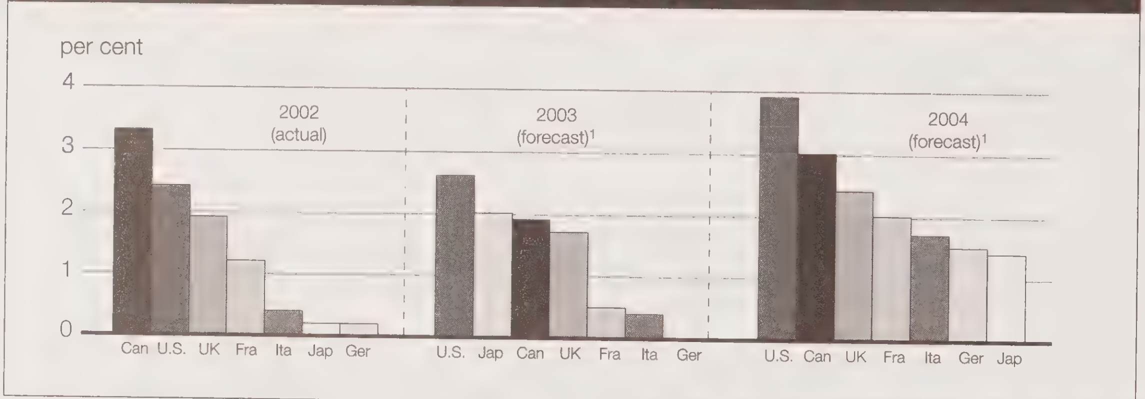
Reflecting recent shocks to the economy, growth in Canada this year and next is expected to be weaker than projected in the 2003 budget

Canadian Real GDP Growth—Private Sector Forecasters



[1] Sources: December 2002 and September 2003 Department of Finance surveys of private sector forecasters.

G-7 Real GDP Growth—International Monetary Fund



[1] Source: IMF, *World Economic Outlook*, September 2003.

- On an average annual basis, private sector economists expect real GDP growth of 1.9 per cent this year, down sharply from the 3.2-per-cent growth they forecast at the time of the 2003 budget. For 2004 they forecast 3-per-cent growth, again down from the 3.5 per cent forecast in the 2003 budget. With real GDP levels lower this year and beyond, this will have ongoing negative impacts on government revenues.

- Canada ranked first in real GDP growth among Group of Seven (G-7) countries in 2002, and the IMF expects Canada to rank third in 2003 and second to the U.S. in 2004. The IMF expects Canadian growth to be lower than in the U.S. in part because of the rapid appreciation of the Canadian dollar and the smaller degree of excess capacity in Canada than in the United States.

- Compared to the February 2003 budget, private sector forecasters expect higher GDP inflation in 2003, at 3.3 per cent. However, GDP inflation is projected to slow to below 2 per cent in 2004.

- Reflecting the slower forecast real GDP growth in 2003, private sector forecasters expect short- and long-term interest rates to be lower in both 2003 and 2004 than anticipated at the time of the February 2003 budget.

- The Canadian outlook has several risks. Principal among these is uncertainty about the outlook for growth in the U.S. and the extent of the adjustment from the appreciation of the Canadian dollar. Private sector economists view the risks to the U.S. outlook as balanced, meaning that growth in the U.S. could be higher or lower with similar probabilities. However, they believe that the extent and the speed of the appreciation of the Canadian dollar, as well as the uncertainty about future levels of the dollar, represent downside risks to their short-term Canadian outlook for growth.

Evolution of the Average Private Sector Forecast for Canada

	2003	2004
	(per cent, unless otherwise indicated)	
Real GDP growth		
February 2003 budget	3.2	3.5
November 2003 update	1.9	3.0
Difference (percentage points)	-1.3	-0.5
GDP inflation		
February 2003 budget	2.2	1.9
November 2003 update	3.3	1.4
Difference (percentage points)	1.1	-0.5
Nominal GDP growth		
February 2003 budget	5.4	5.4
November 2003 update	5.3	4.4
Difference (percentage points)	-0.1	-1.0
Employment growth		
February 2003 budget	2.1	1.8
November 2003 update	1.9	1.3
Difference (percentage points)	-0.2	-0.5
Unemployment rate		
February 2003 budget	7.3	7.0
November 2003 update	7.7	7.7
Difference (percentage points)	0.4	0.7
3-month Treasury bill rate		
February 2003 budget	3.3	4.5
November 2003 update	2.9	2.9
Difference (percentage points)	-0.4	-1.6
10-year government bond rate		
February 2003 budget	5.4	5.9
November 2003 update	4.8	5.0
Difference (percentage points)	-0.6	-0.9

Sources: December 2002 and September 2003 Department of Finance surveys of private sector forecasters.

Annex 3

Private Sector Five-Year Economic and Fiscal Projections

Highlights

- *The Department of Finance meets each fall with the chief economists of the major chartered banks and four private sector economic forecasting firms. The objective of this exercise, which was initiated in 1999, is to agree on a set of economic assumptions for planning purposes, which the four forecasting firms then use to develop status quo fiscal projections of the budgetary balance for each of the next five years.*

- *However, because of the greater degree of uncertainty associated with longer-term projections, budget decisions are made on a rolling two-year horizon.*

- *In order to arrive at an estimate of the fiscal surplus for planning purposes, the average fiscal surplus projections are typically adjusted to include prudence:*

  - *an annual Contingency Reserve to guard against unforeseen developments. If it is not needed, this reserve goes to pay down the debt; and*

  - *economic prudence to provide further assurance against going back into deficit.*

- *Prudence is an essential element of budget planning. The purpose of prudence is to protect the annual balanced budget target against economic shocks and other unexpected developments. For example, in 2001 the unforeseen circumstances of both the global economic slowdown and the terrorist attacks of September 11th created exceptional fiscal pressures. As a result, the prudence absorbed the adverse fiscal impact of these developments and allowed the Government to meet its fiscal targets.*

- *In this update, the downward revisions to economic growth, and the resulting impact on budgetary revenues, will again require that some of the prudence established in the February 2003 budget be used to protect the balanced budget target.*

- *Based on the fiscal results for the first five months of 2003–04, and after accounting for the fiscal impact of the policy initiatives announced since the February 2003 budget, the surplus for 2003–04 is estimated at $2.3 billion. This amount has been allocated to the Contingency Reserve.*

- *Based on the average of the four private sector economic forecasting firms and including the fiscal impact of the policy measures announced since the February 2003 budget, but before any allocation for prudence, the surplus is forecast at $3.0 billion in both 2004–05 and 2005–06, $4.0 billion in 2006–07, $6.0 billion in 2007–08 and $9.5 billion in 2008–09. For the period to 2008–09 these surpluses are allocated to the $3 billion Contingency Reserve and an element of economic prudence.*

Approach to budget planning

- The Government's approach to budget planning involves a number of important steps. The first step involves using private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a regular basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and leading economic forecasting firms.
- The second step involves using these economic assumptions to develop status quo fiscal projections for the regular fall *Economic and Fiscal Update*.
  - Since 1999, for the fall update, major private sector economic forecasting firms develop detailed fiscal projections, on a National Accounts basis, based on tax and spending policies in place at that time, using the average of the private sector economic forecasts.
  - These forecasts are then translated into Public Accounts projections, in consultation with the private sector economic forecasting firms, and presented in the fall *Economic and Fiscal Update* for budget-planning purposes. For the current fiscal year, year-to-date fiscal results are used to estimate the potential outcome, while forecasts for the next five years are based on the average of the fiscal projections provided by the four economic forecasting firms.
  - The impact of policy decisions since the last budget is then subtracted from these fiscal projections.
- The third step adjusts the resulting fiscal projections for prudence to derive the fiscal surpluses for budget-planning purposes.
  - An annual Contingency Reserve is set aside to guard against unforeseen circumstances. If not needed, it reduces the federal debt (accumulated deficit).
  - An extra degree of economic prudence may be built in to provide further assurance against falling back into deficit.
- The Contingency Reserve is normally set at $3 billion annually, while the economic prudence is set at $1 billion in the first year of the five-year planning horizon, rising to $4.0 billion by year five.

- The Contingency Reserve and economic prudence are used to absorb the fiscal impact of short- and longer-term economic and other shocks. They provide a buffer to protect the annual balanced budget target, to avoid having to undo previous budget initiatives, and to avoid going back into deficit.
- It is the view of the private sector economic advisory group that for the purposes of public debate on policy options, a five-year time horizon is appropriate.
- However, it is also the view of the private sector economic advisory group that great caution is warranted in the use of long-term projections as a basis for budget decisions. Therefore, budget decisions continue to be made on a rolling two-year horizon.
- This prudent approach to budget planning has allowed the federal government to record six consecutive fiscal surpluses. In 2002 Canada was the only country among the Group of Seven (G-7) countries to record a budgetary surplus.

Assumptions underlying average private sector fiscal projections

Table 3.1
Average of Private Sector Economic Forecasts: September 2003 Survey

	2003	2004	2005	2006–2008
			(per cent)	
Real GDP growth	1.9	3.0	3.2	3.0
GDP inflation	3.3	1.4	1.9	1.8
Nominal GDP growth	5.3	4.4	5.3	4.9
3-month Treasury bill rate	2.9	2.9	4.1	4.6
10-year Government of Canada bond rate	4.8	5.0	5.4	5.7
			(percentage points)	
Change from the February 2003 budget				
Real GDP growth	-1.3	-0.5	0.2	0.1[1]

Note: Based on a survey conducted by the Department of Finance in mid-September.
The number of respondents declines from 18 in 2003 to 6 in 2008.

[1] Annual average.

- The average private sector forecast of real gross domestic product (GDP) growth is 1.9 per cent in 2003, 3.0 per cent in 2004 and 3.2 per cent in 2005. The average growth forecast over the 2006 to 2008 period is 3.0 per cent.
  - GDP inflation is expected to be 3.3 per cent in 2003, but then decline significantly to 1.4 per cent in 2004 and average around 1.8 per cent to 2008.
  - As a result, nominal GDP growth is estimated at 5.3 per cent in 2003. However, it is forecast to slow to 4.4 per cent in 2004 before rebounding to 5.3 per cent in 2005. Over the 2006 to 2008 period nominal GDP growth is forecast to average 4.9 per cent.
- Short-term interest rates are expected to average 2.9 per cent in both 2003 and 2004, before rising to 4.1 per cent in 2005 and averaging 4.6 per cent over the medium term. Private sector forecasters project a gradual rise in longer-term interest rates between 2003 and 2008.
- Compared to the February 2003 budget, the real GDP growth forecasts have been lowered by 1.3 percentage points in 2003 and by 0.5 percentage points in 2004. However, the private sector economists do not expect that the Canadian economy will grow significantly above its potential growth rate over the medium term. As a result, the lower growth in 2003 and 2004 is not recovered in future years, and nominal income—the broadest measure of the Government's tax base—is forecast to be lower throughout the five-year projection period.

Planning assumptions used to develop five-year fiscal projections

- Based on these economic forecasts, four private sector forecasting firms derived projections of the major components of the federal budgetary balance on a National Accounts basis. These projections were then converted to a Public Accounts basis, on a full accrual basis of accounting, by the Department of Finance. The projections are based on the following assumptions.

  – The projections include the impact of the policy initiatives announced in previous budgets. More specifically, they include the impact of the $100-billion Five-Year Tax Reduction Plan as set out in the October 2000 *Economic Statement and Budget Update*, as well as the further tax relief measures provided in the 2003 budget. They include the impact of the health care agreements reached by first ministers in 2000 and 2003, which will increase cash transfers to the provinces and territories by 7.3 per cent annually on average over the 2000–01 to 2010–11 period. As agreed under the 2003 First Ministers' Accord on Health Care Renewal, the federal government is prepared to put up to an additional $2 billion into health for the provinces at the end of the fiscal year if the Minister of Finance determines during the month of January that there will be a sufficient surplus above the normal Contingency Reserve to permit such an investment. These projections do not include a provision for this investment.

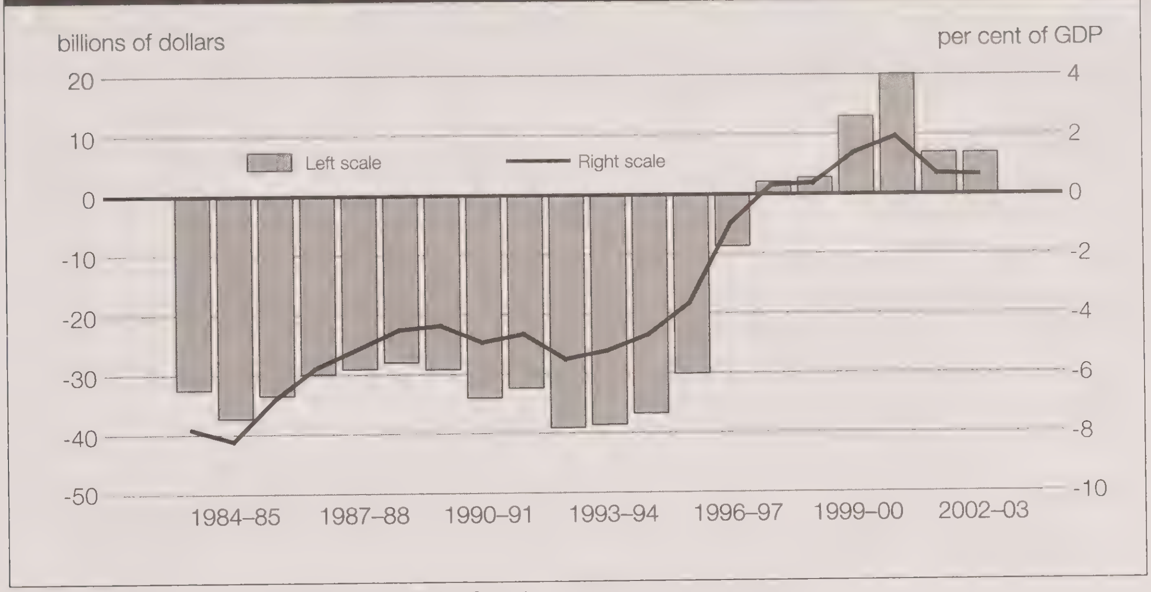
  – In the 2003 budget the Government set the employment insurance (EI) premium rate for 2004 at $1.98 (employee rate per $100 of insurable earnings), down from $2.10 for 2003. Based on the private sector economic forecasts used in the 2003 budget, it was estimated that the rate of $1.98 would generate premium revenues sufficient to cover projected program costs. The four forecasting firms were asked to set forecast premiums equal to their projected program costs on an annual basis for 2005 to 2008.

  – In the February 2003 budget the Government indicated that it would make reallocation from lower to higher priorities an integral part of the way it manages and that the Treasury Board would lead a systematic and ongoing examination of non-statutory government spending. These savings would be ongoing. As part of this commitment, the Government announced that it would reallocate a permanent $1 billion from existing spending beginning in 2003–04. The President of the Treasury Board announced in early October that the savings for 2003–04 have been secured. These projections assume that savings of $1 billion per year will be secured over the period 2004–05 to 2008–09 as well.

  – The projections of public debt charges assume that the Contingency Reserve is not required and is applied each year to reducing the federal debt.

2002–03 fiscal outcome

Budgetary Balance



Sources: *Public Accounts of Canada* and Statistics Canada.

- On a full accrual basis of accounting, there was a budgetary surplus of $7.0 billion in 2002–03. This marks the sixth consecutive year the federal budget has been in surplus. Taken together, federal debt has been reduced by $52.3 billion over the last six years.

- The federal debt-to-GDP ratio is now 44.2 per cent, down sharply from its peak of 68.4 per cent in 1995–96. Market debt—the debt issued on credit markets—as a percentage of GDP has declined to 38.1 per cent from the peak of 57.0 per cent in 1996–97.

- Budgetary revenues increased only 3.4 per cent in 2002–03. As a result, the revenue-to-GDP ratio declined to 15.4 per cent. This reflects both the impact of the Five-Year Tax Reduction Plan and the weaker economy.

- Program expenses increased by 6.6 per cent in 2002–03. As a percentage of GDP, they were 11.5 per cent, up from 11.3 per cent in 2001–02 but well below the level of 15.7 per cent in 1993–94.

- Public debt charges declined by $2.4 billion to $37.3 billion in 2002–03. As a percentage of revenues, they were 21 per cent in 2002–03. In contrast, in 1997–98, the first year the federal budget was balanced and the Government began repaying debt, public debt charges were $43.1 billion and over 28 per cent of revenues.

Fiscal outcome for 2002–03 reflects weakening economy and one-time factors affecting program expenses

Table 3.2
Financial Highlights for 2002–03: Comparison to February 2003 Budget

	(billions of dollars)
February 2003 budget projected surplus	3.0
Changes[1]	
Budgetary revenues	-1.2
Program expenses	5.2
Public debt charges	-0.1
Net change	4.0
Outcome for 2002–03	7.0

Note: Numbers may not add due to rounding.

[1] A positive number implies an improvement in the budgetary balance. A negative number implies a deterioration in the budgetary balance.

- The budgetary surplus for 2002–03 of $7.0 billion reflected lower-than-expected budgetary revenues due to weaker economic growth, but this was more than offset by lower-than-expected program expenses.

- Budgetary revenues were $1.2 billion lower than estimated in the February 2003 budget. The lower revenues in 2002–03 were attributable to much weaker-than-expected personal income tax revenues. Personal income tax revenues were $2.5 billion lower than expected, reflecting weaker-than-expected economic growth at the beginning of 2003. This lower-than-expected outcome for personal income tax revenues has carried forward into 2003–04, as witnessed by the fiscal results for the first five months of 2003–04.

- Program expenses were $5.2 billion lower due in large part to one-time factors, including adjustments to allowances for loans, revisions to accrual adjustments and data revisions which affected prior-year estimates of entitlements under the equalization program.

Status quo fiscal projections
Outlook for 2003–04 to 2008–09

Table 3.3
Surpluses for Purposes of Fiscal Planning

	Actual 2002–03	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
				(billions of dollars)			
Average of private sector fiscal projections	7.0	3.5	3.2	3.2	4.3	6.4	9.7

- The weakness in economic growth in 2003 is reflected in the fiscal results for the first five months of 2003–04. The surplus for the April to August 2003 period was $1.3 billion, down $1.5 billion from the same period in 2002.
  - The lower surplus to date primarily reflects the impact on revenues of the weakness in economic activity in 2003, largely due to a number of domestic shocks.
  - Based on the above, the potential surplus for 2003–04 on a status quo basis is estimated at $3.5 billion.
- The fiscal surplus for the next five years is derived from the average of the private sector fiscal projections.
- The average of the four forecasting firms' fiscal projections, converted to a Public Accounts basis but prior to adjusting for the new policy initiatives, or any allocation for the Contingency Reserve and economic prudence, results in a fiscal surplus of $3.2 billion in both 2004–05 and 2005–06, $4.3 billion in 2006–07, $6.4 billion in 2007–08 and $9.7 billion in 2008–09.
- The relatively small surpluses are attributable to the slower-than-expected economic growth for 2003 and 2004, which have negatively affected federal revenues. Moreover, as the private sector economists do not expect that the Canadian economy will grow significantly above its potential growth rate over the medium term, this means that the weaker growth in the short term is not expected to be made up by stronger growth in the future. As a result, nominal income—the broadest measure of the Government's tax base—is expected to be lower throughout the entire five-year projection period.

Fiscal impact of policy initiatives since the 2003 budget

Table 3.4
Initiatives Announced Since the February 2003 Budget

	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
			(millions of dollars)			
National Defence mission costs	193.0	15.0				
Other international initiatives	27.3	12.6	3.7	3.7	3.7	3.7
Severe acute respiratory syndrome (SARS)						
Offer to Ontario	150.0					
SARS challenges	100.0					
Other	110.0					
Bovine spongiform encephalopathy (mad cow disease)	440.0					
Cod assistance package	49.8	15.8				
Airline industry	15.0					
Employment insurance changes	17.0	29.2	18.8	18.8	18.8	18.8
Hamilton Commonwealth Games	3.7	15.0	21.0	40.0	47.0	28.0
Canadian Television Fund	12.5	-12.5				
World aquatics sports event		4.0	8.5			
Whitehorse Canada Games	1.5	5.2	5.2	1.1		
Drug strategy	20.0	41.3	59.0	59.8	59.9	59.9
Political financing	10.1	35.3	18.1	18.1	18.1	35.3
Aboriginal self-government			13.9	23.7	58.6	58.6
VIA Rail		45.0	56.0	190.0	206.0	
Other	11.4	4.0	3.4	3.4	3.4	3.4
Total	1,161.3	209.9	207.6	358.6	415.5	207.7

- Since the February 2003 budget the Government has announced a number of initiatives, primarily to respond to unexpected developments during 2003. These include:
  - Incremental funding to National Defence to support Canada's international commitments.
  - Funding in the fight against severe acute respiratory syndrome, including $250 million to help the province of Ontario in recognition of its extraordinary effort to protect public health.
  - Assistance to help the Canadian cattle and beef industry to offset the impact of border closures following the discovery of a single cow with bovine spongiform encephalopathy (mad cow disease).
  - Assistance to help fishers and fish plant workers affected by the closure of the cod fisheries.
  - Incremental funding for sports and cultural initiatives, the drug strategy, Aboriginal self-government, VIA Rail and political financing.
- The fiscal cost of these initiatives amount to $1.2 billion in 2003–04, $0.2 billion in 2004–05, rising to $0.4 billion in 2006–07.

Average of private sector projections of the fiscal surplus

Table 3.5
Surpluses for Purposes of Fiscal Planning

	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
	(billions of dollars)					
Average of private sector fiscal projections	3.5	3.2	3.2	4.3	6.4	9.7
Initiatives announced since the February 2003 budget	1.2	0.2	0.2	0.4	0.4	0.2
Average of private sector projections adjusted for policy initiatives	2.3	3.0	3.0	4.0	6.0	9.5
Allocation for prudence						
Contingency Reserve	2.3	3.0	3.0	3.0	3.0	3.0
Economic prudence				1.0	3.0	4.0
Surplus for planning purposes	0.0	0.0	0.0	0.0	0.0	2.5

Note: Numbers may not add due to rounding.

- Table 3.5 first adjusts the projections of the fiscal surplus to include the impact of policy decisions since the February 2003 budget.
  - As a result, the surplus is reduced to $2.3 billion in 2003–04, $3.0 billion in both 2004–05 and 2005–06, $4.0 billion in 2006–07, $6.0 billion in 2007–08 and $9.5 billion in 2008–09.
- Second, the projections are adjusted to take into account the Contingency Reserve and some allocation for economic prudence.
  - For 2003–04 the Contingency Reserve is $2.3 billion, equal to the average private sector surplus, adjusted for initiatives since the February 2003 budget.
  - For 2004–05 and beyond, the Contingency Reserve is set at its normal level of $3 billion per year.
  - The economic prudence is $1.0 billion in 2006–07, $3.0 billion in 2007–08 and $4.0 billion in 2008–09.

Average of private sector fiscal projections

Table 3.6
Summary Statement of Transactions

	Actual 2002–03	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
			(billions of dollars)				
Budgetary transactions							
Budgetary revenues	177.6	180.5	186.3	195.5	204.4	213.9	224.6
Total expenses							
Program expenses	-133.3	-142.1	-147.1	-155.3	-162.6	-170.4	-177.9
Public debt charges	-37.3	-36.2	-36.2	-37.2	-37.8	-37.6	-37.2
Total expenses	-170.6	-178.2	-183.3	-192.5	-200.3	-207.9	-215.1
Budgetary surplus	7.0	2.3	3.0	3.0	4.0	6.0	9.5
Prudence							
Contingency Reserve		2.3	3.0	3.0	3.0	3.0	3.0
Economic prudence					1.0	3.0	4.0
Total		2.3	3.0	3.0	4.0	6.0	7.0
Planning surplus	7.0	0.0	0.0	0.0	0.0	0.0	2.5
Non-budgetary transactions							
Pension and other accounts	0.4	-0.6	-1.4	2.6	2.5	2.2	2.0
Capital investing activities	-4.8	-4.8	-4.9	-5.1	-5.4	-5.7	-6.0
Other investing activities	0.8	-1.4	-1.5	-1.3	-1.2	-1.2	-1.2
Other activities	4.2	1.0	5.7	5.9	6.0	6.2	6.2
Total	0.6	-5.8	-2.1	2.0	1.9	1.6	1.0
Financial source/requirement	7.6	-5.8	-2.1	2.0	1.9	1.6	3.5
Per cent of GDP							
Budgetary revenues	15.4	14.8	14.7	14.6	14.6	14.5	14.6
Program expenses	11.5	11.7	11.6	11.6	11.6	11.6	11.5
Public debt charges	3.2	3.0	2.9	2.8	2.7	2.6	2.4
Total expenses	14.8	14.7	14.4	14.4	14.3	14.1	13.9
Planning surplus	0.6	0.0	0.0	0.0	0.0	0.0	0.2
Federal debt							
Assuming balanced budget	44.2	42.0	40.2	38.2	36.4	34.7	33.1
Assuming Contingency Reserve applied to debt reduction	44.2	41.8	39.8	37.6	35.5	33.5	31.5

Note: Numbers may not add due to rounding.

- Table 3.6 sets out the details of the fiscal projections to 2008–09 based on the September 2003 survey of private sector economic projections.

- The budgetary balance is presented on a full accrual basis of accounting, recording government liabilities and assets when they are incurred or acquired, regardless of when the cash payment or receipt is made. In contrast, the financial source/requirement measures the difference between cash coming in to the Government and cash going out. It differs from the budgetary balance as it includes the cash source/requirement resulting from the Government's investing activities through its acquisition of capital assets and loans, investments and advances, as well as from operating transactions, primarily through the federal employees' pension accounts and foreign exchange accounts. These transactions are recorded as non-budgetary transactions.
  - There was a financial source of $7.6 billion in 2002–03, primarily attributable to the budgetary surplus of $7.0 billion.
  - With projected budgetary balances, there is a projected financial requirement of $5.8 billion in 2003–04 and $2.1 billion in 2004–05, unchanged from the estimates at the time of the February 2003 budget. The requirement in 2003–04 reflects the cash transfers to the trust funds established in the February 2003 budget for the Canada Health and Social Transfer supplement of $2.5 billion and the Diagnostic/Medical Equipment Fund of $1.5 billion. The liabilities for these trust transfers were established in 2002–03 and affected the budgetary balance in that year. The proposed transfer of the Government's holdings in the Canada Pension Plan to the Canada Pension Plan Investment Board also impacts the financial requirements for 2003–04 and 2004–05. The Government will fund these cash requirements without raising new debt.
  - In the absence of the special factors noted above, financial sources are projected for 2005–06 and beyond.

- The revenue-to-GDP ratio was 15.4 per cent in 2002–03, down significantly from 17.0 per cent in 2000–01, primarily reflecting the impact of tax reduction measures. It is expected to decline to 14.8 per cent in 2003–04 and to 14.7 per cent in 2004–05, reflecting weaker economic growth and the impact of the Five-Year Tax Reduction Plan. The revenue ratio drops to 14.6 per cent in 2005–06, reflecting the tax reductions announced in the February 2003 budget, and remains relatively stable thereafter.

- The program expenses-to-GDP ratio was 11.5 per cent in 2002–03, well below the level of 15.7 per cent in 1993–94. It is projected to increase slightly in 2003–04, as some of the factors that reduced expenses in 2002–03 do not carry forward into 2003–04. It is projected to remain relatively stable thereafter.

- The federal debt-to-GDP ratio (accumulated deficit) stood at 44.2 per cent in 2002–03, down from its peak of 68.4 per cent in 1995–96. Assuming no incremental debt reduction, it would fall to about 33 per cent by 2008–09. If the Contingency Reserve is not needed and is used to reduce federal debt, the federal debt-to-GDP ratio would decline to 31.5 per cent in 2008–09.

Average private sector projections of budgetary revenues

Table 3.7
Average Private Sector Projections of Budgetary Revenues

	Actual 2002–03	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
				(millions of dollars)			
Tax revenues							
Income tax							
Personal income tax	81,707	83,440	86,025	91,105	96,200	102,375	109,530
Corporate income tax	22,222	23,450	24,755	26,095	26,855	26,990	26,860
Other income tax	3,291	3,315	3,455	3,585	3,710	3,825	3,895
Total income tax	107,220	110,205	114,235	120,785	126,765	133,191	140,285
Excise taxes/duties							
Goods and services tax	28,248	29,260	31,170	32,865	34,585	36,425	38,475
Customs import duties	3,221	3,130	3,440	3,915	4,225	4,445	4,710
Energy taxes	2,496	2,525	2,585	2,650	2,700	2,735	2,775
Other excise taxes/duties	6,971	6,920	7,080	7,235	7,380	7,550	7,815
Air Travellers Security Charge	421	375	395	415	430	445	460
Total	41,357	42,210	44,670	47,080	49,320	51,600	54,235
Total tax revenues	148,577	152,415	158,905	167,865	176,085	184,790	194,520
Employment insurance premium revenues	17,870	17,500	17,135	16,965	17,420	18,035	18,730
Other revenues	11,115	10,575	10,250	10,700	10,850	11,100	11,330
Total budgetary revenues	177,562	180,490	186,290	195,530	204,355	213,925	224,580
Per cent of GDP							
Personal income tax	7.1	6.9	6.8	6.8	6.9	7.0	7.1
Corporate income tax	1.9	1.9	1.9	2.0	1.9	1.8	1.7
Goods and services tax	2.4	2.4	2.5	2.5	2.5	2.5	2.5
Other excise	1.1	1.1	1.1	1.1	1.0	1.0	1.0
Tax revenues	12.9	12.5	12.5	12.6	12.5	12.6	12.6
Employment insurance premium revenues	1.5	1.4	1.3	1.3	1.2	1.2	1.2
Non-tax revenues	1.0	0.9	0.8	0.8	0.8	0.8	0.7
Total	15.4	14.8	14.7	14.6	14.6	14.5	14.6

Note: Numbers may not add due to rounding.

- Budgetary revenues are projected to increase by only 1.6 per cent in 2003–04, primarily reflecting the weakness in the economy in 2003. Beyond 2003–04, the average of the private sector forecasts for revenue growth is broadly in line with the growth in nominal GDP, with variations largely due to the impact of tax reductions announced as part of the $100-billion Five-Year Tax Reduction Plan and in the 2003 budget.

- Personal income tax—the largest component of budgetary revenues—declines as a percentage of GDP to 2005–06, reflecting both the impact of the $100-billion Five-Year Tax Reduction Plan, which matures in 2004–05, and weakness in economic growth. Thereafter it increases slightly as a percentage of GDP, reflecting the progressivity of the income tax system.

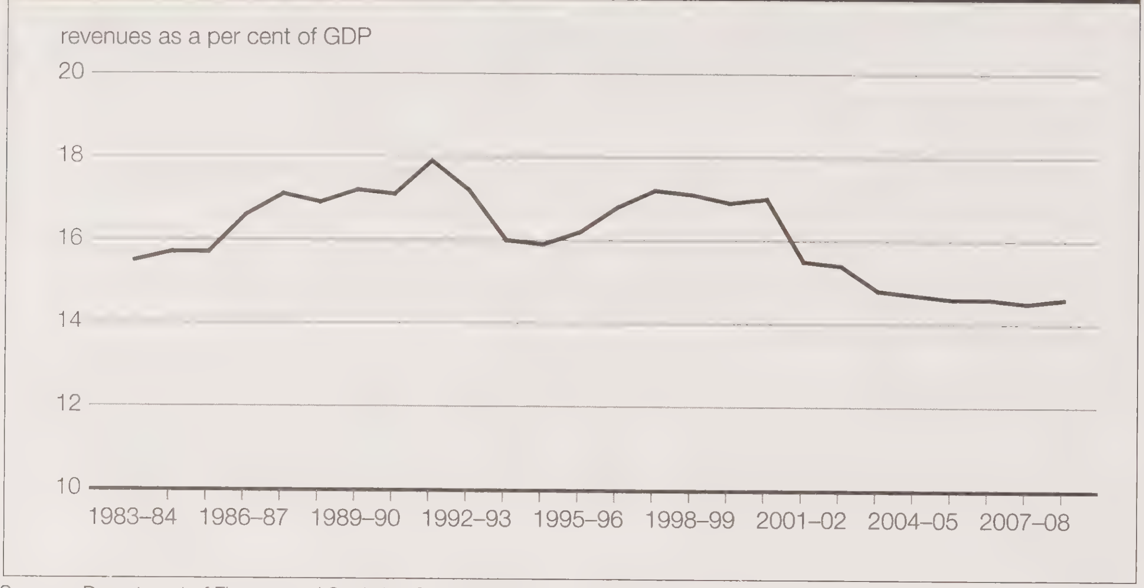
- Corporate income tax revenues grow broadly in line with the growth in the economy to 2005–06, despite reductions in the general rate to 21 per cent from 28 per cent in 2000. Beyond 2005–06 they grow somewhat slower than the growth in nominal GDP, in part reflecting the impact of the tax reductions implemented in the February 2003 budget.

- Excise taxes and duties are expected to increase by only 2.1 per cent in 2003–04, following an increase of 11.4 per cent in 2002–03. The 2002–03 results were affected by the introduction of the Air Travellers Security Charge, tobacco tax increases and a strong increase in goods and services tax revenues. The slower pace expected for 2003–04 reflects the weakening in consumer demand. Thereafter they are expected to pick up somewhat and grow broadly in line with the growth in nominal GDP.

- The annual decline in EI premium revenues to 2004–05 reflects the impact of lower EI premium rates. Under current legislation, rates decline from $2.20 in 2002 (employee rate per $100 of insurable earnings) to $1.98 in 2004. Over the period 2005–06 to 2008–09 EI premium revenues are assumed to match EI program costs.

- Other revenues include revenues from enterprise Crown corporations, foreign exchange revenues, return on investments and sales of goods and services. These revenue sources are extremely volatile, determined in large part by changes in the value of the Canadian dollar and net gains/losses from enterprise Crown corporations. For planning purposes, they are assumed to grow slower than the growth in the economy.

Revenue Ratio



Sources: Department of Finance and Statistics Canada.

- A more revealing picture of movements in tax revenue can be obtained by examining the "revenue ratio"—total federal revenues in relation to the total income in the economy (or GDP).

- This ratio primarily reflects the impact of policy decisions and economic developments. The ratio declines during economic downturns and tends to increase during recoveries, reflecting the progressive nature of the tax system and the cyclical nature of corporate profits.

- The decrease in the ratio in 2001-02 was largely attributable to the implementation of the $100-billion Five-Year Tax Reduction Plan. Thereafter the decline in the ratio reflects both the incremental impact of the Tax Reduction Plan and the tax reductions announced in the February 2003 budget and weaker economic growth than expected at the time of the February 2003 budget.

- The revenue ratio is projected to decline from 17.0 per cent in 2000–01 to 14.6 by 2008–09—a level not seen since the early 1960s.

Average private sector projections of program expenses

Table 3.8
Average Private Sector Projections of Program Expenses

	Actual 2002–03	Estimate 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
	(millions of dollars)						
Major transfers to persons							
Elderly benefits	25,692	27,015	27,940	28,975	30,120	31,355	32,740
Employment insurance benefits	14,496	15,450	15,495	15,630	16,040	16,560	17,210
Total	40,188	42,465	43,434	44,605	46,160	47,916	49,950
Major transfers to other levels of government							
Federal transfers in support of health and other programs	22,600	20,300	21,900	24,500	26,100	27,700	28,900
Fiscal arrangements	10,366	11,025	12,130	12,740	13,335	13,950	14,590
Alternative Payments for Standing Programs	-2,321	-2,440	-2,550	-2,685	-2,820	-2,955	-3,100
Total	30,645	28,885	31,480	34,555	36,615	38,695	40,390
Other program expenses	62,490	70,700	72,150	76,150	79,800	83,750	87,550
Total program expenses	133,323	142,050	147,064	155,310	162,575	170,361	177,890
Per cent of GDP							
Major transfers to persons							
Elderly benefits	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Employment insurance benefits	1.3	1.3	1.2	1.2	1.1	1.1	1.1
Total	3.5	3.5	3.4	3.3	3.3	3.3	3.2
Major transfers to other levels of government							
Federal transfers in support of health and other programs	2.0	1.7	1.7	1.8	1.9	1.9	1.9
Fiscal arrangements	0.9	0.9	1.0	1.0	1.0	0.9	0.9
Alternative Payments for Standing Programs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Total	2.7	2.4	2.5	2.6	2.6	2.6	2.6
Other program expenses	5.4	5.8	5.7	5.7	5.7	5.7	5.7
Total program expenses	11.5	11.7	11.6	11.6	11.6	11.6	11.5

Note: Numbers may not add due to rounding.

Average private sector projections of program expenses

- The projections of program expenses in Table 3.8 include the impact of the health care agreements reached in September 2000 and February 2003, as well as initiatives announced in the February 2003 budget. They also include initiatives announced since the 2003 budget, which are shown in Table 3.4.

- Program expenses are divided into three major components: major transfers to persons, major cash transfers to other levels of government and other program expenses—the latter include subsidies and other transfers, and expenses of Crown corporations, defence and all other departmental operating expenses.

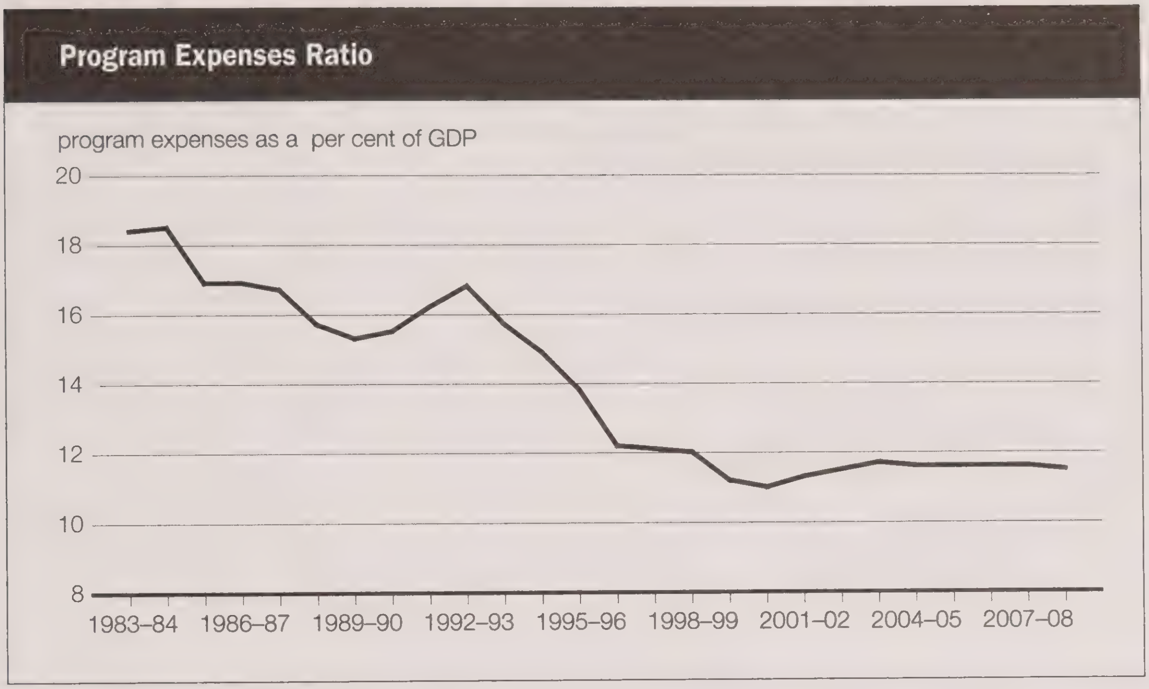
- Program expenses are expected to increase by 6.5 per cent, or $8.7 billion, in 2003–04, with most of the increase due to higher other program expenses, reflecting in part the impact of initiatives announced in the February 2003 budget, including incremental funding for National Defence, affordable housing, infrastructure, research and innovation, and climate change, as well as the initiatives announced since the 2003 budget. Thereafter, based on the average of the projections provided by the four forecasting firms, total program expenses are estimated to increase broadly in line with the increase in nominal GDP.

- Major transfers to persons, consisting of elderly benefits and EI benefits, are expected to increase by $2.3 billion in 2003–04. The growth in elderly benefits is largely determined by the growth in the elderly population and average benefits, which are fully indexed to quarterly changes in consumer prices. The growth in EI benefits reflects the lagged impact of the economic slowdown and increases in average benefits.

- Cash entitlements to other levels of government in 2002–03 include one-time funding totalling $4.0 billion, of which $2.5 billion was for the Canada Health and Social Transfer cash supplement and $1.5 billion for the Diagnostic/Medical Equipment Fund. The inclusion of these one-time transfers accounts for the drop in cash entitlements in 2003–04. Cash transfers in support of health and other social programs reflect the planned levels for total cash entitlements to 2008–09 as set out in the February 2003 budget. Fiscal arrangements include equalization entitlements, transfers to the territories, statutory subsidies and recoveries under the Youth Allowance Recovery Program. Renewal of the equalization program is currently under discussion with the provinces. Until a new five-year legislated program is enacted, it is assumed for planning purposes that equalization entitlements will grow in line with nominal GDP.

- Other program expenses are projected to grow by 13 per cent in 2003–04. This increase is attributable to the impact of one-time adjustments, which lowered spending in this component in 2002–03, and the impact of the February 2003 budget initiatives, which came into effect in 2003–04. Thereafter this component is projected to grow in line with the growth in nominal GDP.

Program expenses-to-GDP ratio continues to decline



Source: Department of Finance.

- Program expenses as a per cent of GDP, on a status quo basis, are expected to increase slightly, from 11.5 per cent in 2002–03 to 11.7 per cent in 2003–04.
- The ratio has declined significantly from the levels of the 1980s and early 1990s. This is primarily attributable to the expenditure reduction measures implemented in the 1995 and 1996 budgets, which structurally lowered program expenses.
- Since 1996–97 the ratio has been relatively stable and is expected to remain so over the outlook period.

Sensitivity of the fiscal outlook to economic shocks

Table 3.9
Estimated Change in Fiscal Position

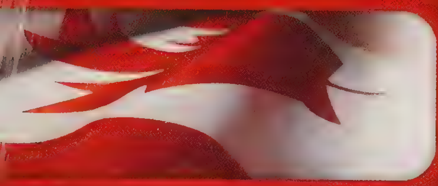
	Year 1	Year 2
	(billions of dollars)	
1-per-cent decrease in real GDP growth		
Revenue impact	-1.9	-1.9
Expenses impact	0.6	0.7
Deterioration in fiscal balance	-2.5	-2.6
1-per-cent decrease in GDP inflation		
Revenue impact	-1.9	-1.8
Expenses impact	-0.5	-0.5
Deterioration in fiscal balance	-1.4	-1.3
100-basis-point decrease in interest rates		
Revenue impact	-0.4	-0.5
Expenses impact	-1.2	-1.8
Improvement in fiscal balance	0.8	1.3

- The fiscal projections are extremely sensitive to changes in economic assumptions—particularly to changes in real economic (GDP) growth, inflation and interest rates. To ensure that such developments do not adversely affect the achievement of the Government's balanced budget target, the Government follows a prudent approach to budget planning, as described earlier in this annex.

- A decrease in the growth of real GDP (through equal reductions in employment and productivity) would lead to lower federal government revenues through a contraction in various tax bases, and an increase in expenses, primarily due to higher EI benefits. Using standard sensitivity analysis, a 1-per-cent decrease in real GDP for one year would lower the budgetary balance by $2.5 billion in the first year and by $2.6 billion in the second year.

- A 1-per-cent reduction in the growth in nominal GDP resulting solely from a one-year decline in the rate of GDP inflation would lower the budgetary balance by $1.4 billion in the first year and $1.3 billion in year two. Most of the impact would be on budgetary revenues, as wages and profits would be lower, as well as the price of goods and services subject to sales and excise taxes. The impact on expenses would be largely reflected in those programs that are indexed to inflation, such as elderly benefit payments.

- A sustained 100-basis-point decline in all interest rates would improve the budgetary balance by $0.8 billion in the first year, rising to $1.3 billion in year two. This improvement comes solely from the reduction in public debt charges, which would reduce overall budgetary expenses by $1.2 billion in the first year and $1.8 billion in year two, as longer-term debt matures and is refinanced at the lower rates. Moderating this impact are somewhat lower interest earnings on the Government's interest-bearing assets, which are recorded as part of other revenues.



The ECONOMIC and FISCAL UPDATE

Annexes to the Presentation

November 16, 2004

Canada

ECONOMIC AND FISCAL UPDATE

Annexes to the Presentation

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Foreword

This document contains four background annexes to the Economic and Fiscal Update presentation by Minister of Finance Ralph Goodale on November 16, 2004, to the House of Commons Standing Committee on Finance.

The annexes provide details on Canada's fiscal progress, economic developments and prospects, as well as private sector five-year economic and fiscal projections.

As in the past, four private sector forecasting organizations were asked to provide fiscal projections for the current year and the next five years, based on common economic assumptions obtained from a survey of 18 private sector economists.

This year's Update includes the following new features to further enhance transparency:

- Annex 3 includes the individual projections of the budgetary balance from the four forecasting organizations, as well as the average.

- Annex 4 provides the details of how the private sector fiscal projections, which were prepared on a National Accounts basis (the accounting system used by Statistics Canada and the Organisation for Economic Co-operation and Development), are translated to a Public Accounts basis, the accounting system used by the Government to present the budget.

Annex 1

Canada's Fiscal Progress

Highlights

- *The audited budgetary surplus for 2003–04 was $9.1 billion. This was significantly better than expected at the time of the March 2004 budget, mainly owing to higher-than-expected revenues.*

- *The Government has recorded seven consecutive budgetary surpluses since 1997–98, and as a result the federal debt has been reduced by more than $61 billion. This has resulted in ongoing savings of public debt charges of over $3 billion annually.*

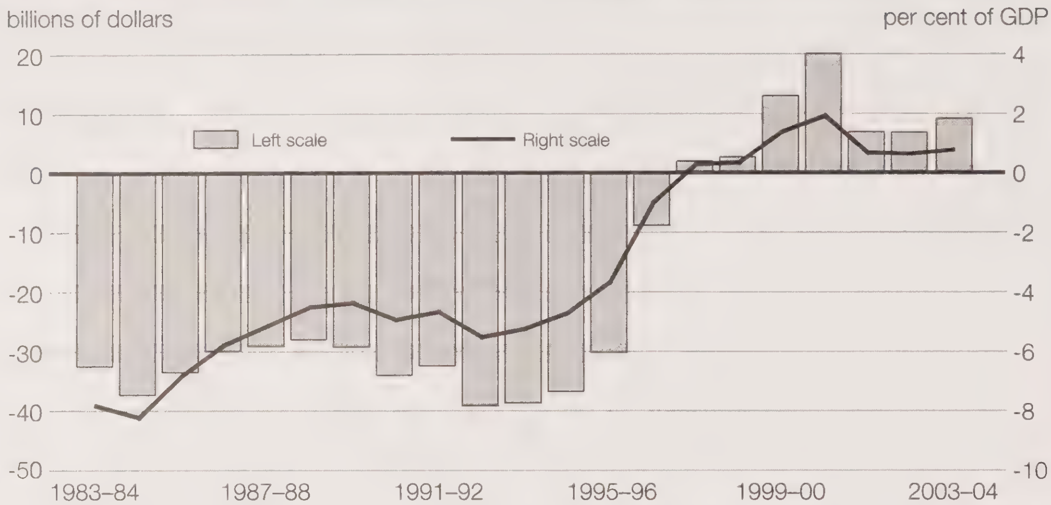
- *The federal debt-to-GDP (gross domestic product) ratio fell to 41.1 per cent in 2003–04, down from its peak of 68.4 per cent in 1995–96. As a result of this reduction in the federal debt, public debt charges as a share of revenues have fallen to just over 19 per cent—the lowest level since the late 1970s.*

- *The "virtuous circle" of improved fiscal and economic performance has resulted in increased government revenues, which have given the Government the means to invest in key priority areas, while at the same time allowing it to continue meeting its fiscal targets. Recently the Government committed to provide new funding of nearly $75 billion over the next 10 years to the provinces and territories in support of health, equalization and Territorial Formula Financing, providing the provinces and territories with a growing and predictable revenue track.*

- *Canada's fiscal situation is among the strongest in the world. In 2003 Canada was the only Group of Seven (G-7) country to post a total government surplus, and is expected to be the only G-7 country to do so again this year and next.*

Seventh consecutive budgetary surplus

Federal Budgetary Balance



Sources: *Public Accounts of Canada* and Statistics Canada.

- The Government of Canada posted a budgetary surplus of $9.1 billion in 2003–04, marking the seventh consecutive year in which it has recorded a surplus—the first time this has occurred since Confederation.
- The budgetary surplus was equivalent to 0.7 per cent of GDP in 2003–04.
- As a result, the federal debt (accumulated deficit) has been reduced by more than $61 billion over the past seven years.

Federal Debt (Accumulated Deficit)

Since 2002–03 the financial statements of the Government of Canada have been presented on a full accrual basis of accounting. Under the previous accounting standard—modified accrual accounting—net debt and the accumulated deficit were identical. Under the new standard, net debt now includes a comprehensive costing for financial liabilities but excludes non-financial assets. The accumulated deficit includes both. It is the sum of all surpluses and deficits in the past.

Federal debt, referred to in the fall Economic and Fiscal Update, the budget documents and the *Annual Financial Report of the Government of Canada*, is the accumulated deficit. It is the federal government's main measure of debt, as annual changes in this measure determine the budgetary balance.

Surplus in 2003–04 was applied against the federal debt

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles for senior levels of government state that the surplus for any fiscal year can only take into account the events, transactions and government decisions that have been made before the end of that fiscal year.

- The practice of applying the surplus against the debt is in keeping with Generally Accepted Accounting Principles set by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants.
- According to these accounting principles, expenditures for liabilities that have not occurred in a given year cannot be booked in that year.
- As a result, once a fiscal year has ended, the Government cannot retroactively book new initiatives in that year. The year-end surplus must be applied against the federal debt (accumulated deficit).

Federal debt reduced by $61.4 billion since 1996–97

Table 1.1
Federal Government Assets and Liabilities

	1996–97	2003–04	Change
		(billions of dollars)	
Liabilities			
Accounts payable and accrued liabilities	74.3	80.0	5.7
Interest-bearing debt			
Unmatured debt (market debt)	478.8	440.2	-38.6
Pension and other accounts	156.3	180.9	24.6
Total	635.1	621.1	-14.0
Total liabilities	709.4	701.1	-8.3
Financial assets	100.4	144.8	44.4
Net debt	609.0	556.3	-52.7
Non-financial assets	46.1	54.8	8.7
Federal debt (accumulated deficit)	562.9	501.5	-61.4

- The federal debt (accumulated deficit) was $501.5 billion in 2003–04, a reduction of $61.4 billion from its peak of $562.9 billion in 1996–97.
- Federal debt consists of liabilities, financial assets and non-financial assets.
- Total liabilities include interest-bearing debt and other liabilities. Total liabilities have declined by $8.3 billion since 1996–97. This is due to a $38.6-billion reduction in market debt, partially offset by increases in accounts payable and liabilities to the public sector pension and other accounts.
- Financial assets consist of cash and accounts receivable, including tax receivables, foreign exchange accounts, and loans, investments and advances. Non-financial assets consist of tangible capital assets, inventories and prepaid expenses.
  - Total financial assets have increased by $44.4 billion since 1996–97.
  - Non-financial assets totalled $54.8 billion in 2003–04, up $8.7 billion from 1996–97.

Better-than-expected results for 2003–04 due to higher revenues and lower program expenses

Table 1.2
Comparison of Actual Outcomes for 2003–04 to March 2004 Budget Forecast

	(billions of dollars)
March 2004 budget projected surplus	1.9
Changes	
Budgetary revenues	5.1
Program expenses	2.0
Public debt charges	0.0
Net change	7.2
Outcome for 2003–04	**9.1**

Note: Figures may not add due to rounding.

- In the March 2004 budget, a surplus of $1.9 billion was projected for 2003–04. The final audited budgetary surplus for 2003–04 was $9.1 billion.
- Most of this improvement is attributable to $5.1 billion in higher-than-expected budgetary revenues, which reflect, in part, the strong growth in nominal income in the last quarter of 2003–04, confirmed by the National Accounts figures released by Statistics Canada at the end of August.
- As well, information received well after the end of the fiscal year indicated that tax revenues with respect to the 2003 taxation year were higher than expected due to a higher revenue yield—the revenues the Government collects from each dollar of income.
- The very strong growth in income tax revenues in part reflected one-time factors affecting corporate income tax revenues.
  - Corporate income tax revenues increased by over 23 per cent despite the fact that corporate profits increased by only 10 per cent and the general corporate tax rate was reduced by 2 percentage points as of January 2003.
  - However, about $2.5 billion in corporate income tax revenues in 2003–04 resulted from a one-time gain from the revaluation of U.S.-dollar-denominated liabilities in the financial services industry as a result of the appreciation of the Canadian dollar in 2003.
- In addition, personal income tax revenues rose more rapidly than underlying personal income despite the impact of the $100-billion Five-Year Tax Reduction Plan. Other revenues were also higher than expected.
- Program expenses were $2.0 billion lower than expected in the March 2004 budget, mainly attributable to higher-than-expected lapses in direct program expenses.

Other countries also recorded better-than-expected results in 2003–04

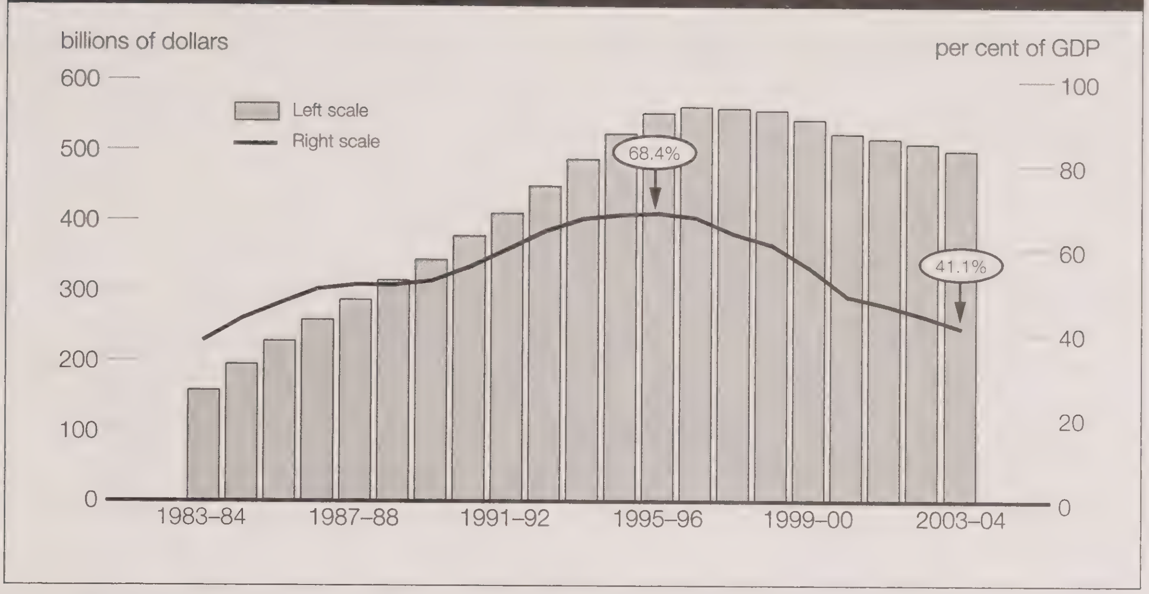
2003–04 Actual Outcomes Compared to 2004 Budget In-Year Estimates

Sources: Individual country budgets. Differences between 2003–04 actual fiscal outcomes and in-year fiscal estimates from 2004 central government budgets.

- Several other major industrialized countries also reported better-than-expected results for the 2003–04 fiscal year, primarily reflecting higher-than-expected revenues.
- Eight of the ten major countries that have to date released final or preliminary results for 2003–04 recorded a better budgetary balance in 2003–04 than estimated in their respective 2004 budgets. Higher-than-expected revenues were the main source of the improvement. Nevertheless, lower spending also had an impact for most countries.
- Only France and Germany realized worse-than-expected fiscal results in 2003–04.

The federal debt burden has been reduced significantly...

Federal Debt (Accumulated Deficit)
(Public Accounts Basis)



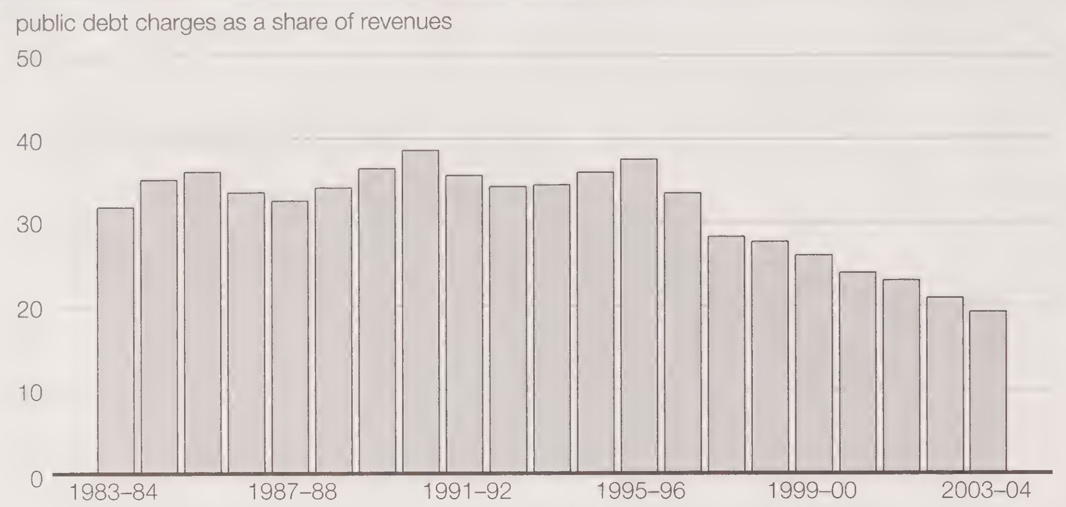
Sources: *Public Accounts of Canada* and Statistics Canada.

- The federal debt-to-GDP ratio is the most appropriate measure of the debt burden, as it measures the federal debt (accumulated deficit) relative to the ability of the nation's taxpayers to finance it.

- As a result of the $61.4-billion reduction in the federal debt (accumulated deficit) over the last seven years and sustained economic growth, the federal debt-to-GDP ratio has fallen by 27.3 percentage points to 41.1 per cent in 2003–04, down from its peak of 68.4 per cent in 1995–96.

...reducing federal debt charges as a share of revenues...

Interest Ratio



Sources: *Public Accounts of Canada* and Statistics Canada.

- The reduction in federal debt since 1996–97 has resulted in ongoing savings in interest payments of over $3 billion annually.
- In 1995–96, 37.6 cents of every revenue dollar went to service the federal debt. In 2003–04, this ratio fell to just over 19 cents, the lowest level since the late 1970s.

...leaving more federal revenues for key priorities

Major Investments in the Priorities of Canadians

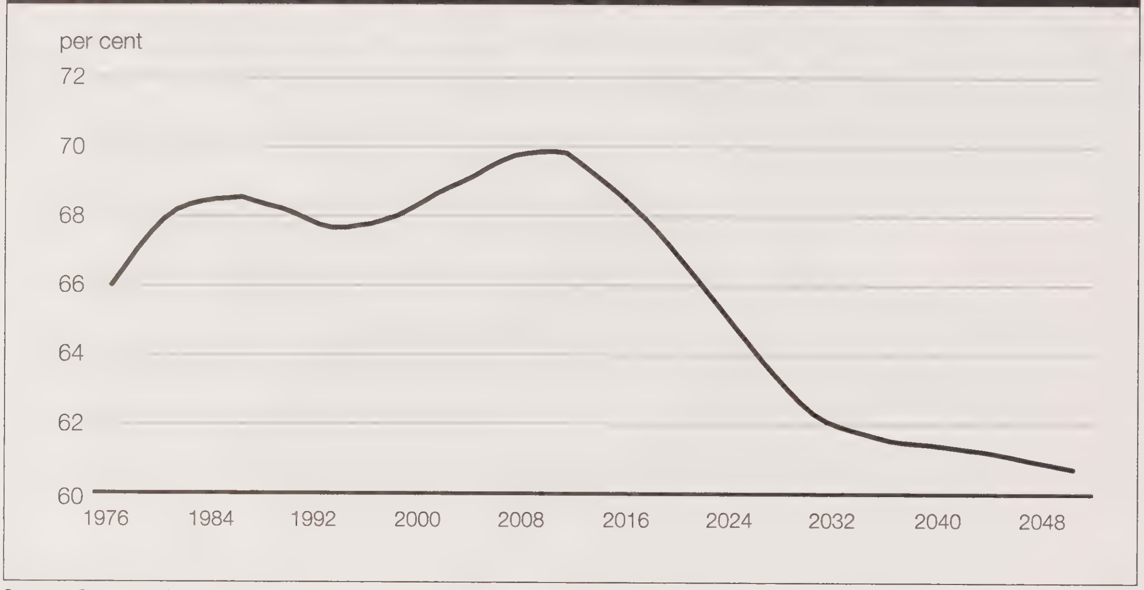
- $100-billion Five-Year Tax Reduction Plan—the largest tax cut in Canadian history
- Investments in key social and economic programs
- $75 billion in new funding for health care, equalization and Territorial Formula Financing

- The Government of Canada has turned chronic annual deficits into sustained annual surpluses and a lower federal debt. This, combined with low inflation, has led to low interest rates, strong consumer and business confidence, and renewed growth in the standard of living of Canadians.

- This "virtuous circle" of improved fiscal and economic performance has resulted in increased government revenues—which have given the Government the means to invest in key priority areas, including:
  - The $100-billion Five-Year Tax Reduction Plan announced in 2000, which is fully implemented as of 2004–05.
  - Key social and economic programs, such as:
    - Measures in support of low- and modest-income families.
    - Initiatives to support and encourage the acquisition of skills and learning.
    - Investment in innovation and research and development.
  - Nearly $75 billion in total new funding recently announced as part of the 10-Year Plan to Strengthen Health Care and the new framework for equalization and Territorial Formula Financing (TFF).

The aging of the population will bring new pressures

Historical and Projected Population Aged 15–64 as a Proportion of Total Population

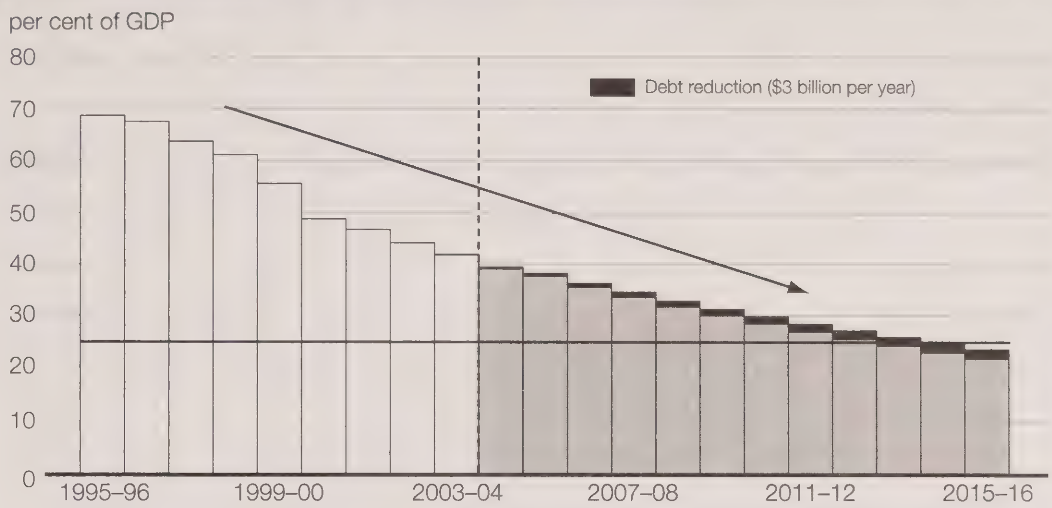


Source: Statistics Canada.

- Canada's population will begin to age sharply within the next 10 years, owing mainly to the aging of the "baby boom" generation as well as continued increases in life expectancy and declines in fertility rates. This means that Canada's overall population, which is currently growing by around 1 per cent each year, is expected to begin to decline by the middle of this century. These trends will only be partly offset by continued immigration.
- These factors will have a significant impact on our workforce. Currently there are more than five people of working age for every person of retirement age. Within the next 15 years, this ratio will fall to four people of working age for every person 65 years of age and older.
- Population aging will put significant pressure on Canada's public finances. Government program spending will increase as a result of increased demand for social programs, in particular health care and public pensions.
- Continued debt reduction will help the Government to better deal with the fiscal challenges associated with population aging and will provide it with the flexibility needed to foster long-run economic and productivity growth.

The federal debt remains on a permanent downward track

Federal Debt-to-GDP Projections (Accumulated Deficit)
(Public Accounts Basis)



Sources: *Public Accounts of Canada*; Statistics Canada; Department of Finance calculations.

- The Government announced in Budget 2004 that it was setting an objective of reducing the federal debt-to-GDP ratio to 25 per cent within 10 years.
- The Government is on track to meet or better this long-term debt objective. This would bring the federal debt-to-GDP ratio back to where it was in the mid-1970s.
- Reducing the federal debt-to-GDP ratio to 25 per cent would mean that about 12 cents of every revenue dollar would go to service the debt compared to about 19 cents in 2003–04.

Canada's strong fiscal position reflects a prudent approach to budget planning

Prudent Approach to Fiscal Planning
Sound fiscal management ■ Balanced budgets or better ■ Average of private sector economic forecasts ■ Contingency Reserve and economic prudence

- The significant turnaround in Canada's fiscal situation and uninterrupted surpluses since 1997–98 are the result of sound fiscal management based on:
  - A commitment to balanced budgets or better.
  - The use of the average of private sector economic forecasts for fiscal planning.
  - A prudent approach to fiscal planning, which entails including in the budget plan an annual Contingency Reserve to guard against unforeseen circumstances, which if not needed reduces the federal debt. Additional economic prudence is also incorporated, which if not needed may be used to fund other priorities.

Sound fiscal management has allowed the Government to make long-term commitments

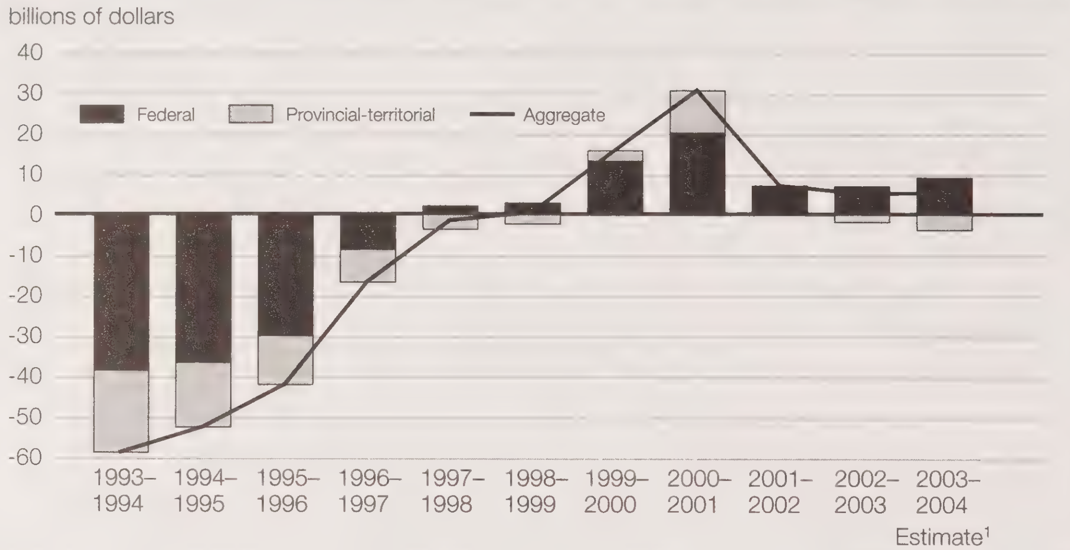
Table 1.3
New Federal Investments Under the 10-Year Plan to Strengthen Health Care and New Frameworks for Equalization and Territorial Formula Financing (TFF)

	Cumulative 10-year investment
	(billions of dollars)
Increased Canada Health Transfer levels	35.3
Wait times reduction	5.5
Medical equipment	0.5
Total new funding for health care	**41.3**
New equalization framework	28.8
New TFF framework	4.6
Total new equalization and TFF funding	**33.4**

- Prudent fiscal planning and the significant reduction in the federal debt have allowed the Government to make major investments in the priorities of Canadians, while at the same time allowing it to continue meeting its fiscal targets.
- The most recent example of this is the proposed new funding of nearly $75 billion over the next 10 years provided to the provinces and territories in support of health care, equalization and TFF (subject to passage of authorizing legislation), which provides the provinces and territories with a growing and predictable revenue track.
  - On September 16, 2004, Canada's First Ministers signed the 10-Year Plan to Strengthen Health Care. Under this plan, the Government of Canada will provide $41.3 billion in new health care funding over the next 10 years to reduce wait times and improve access to care.
  - A new framework for equalization and TFF will ensure that payments to the provinces and territories increase by $33.4 billion over the next 10 years relative to Budget 2004 levels for 2004–05. The Government also commits to review the overall funding levels of equalization and TFF after five years.

The federal-provincial-territorial sector is expected to be in surplus for the sixth consecutive year in 2003–04

Federal and Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



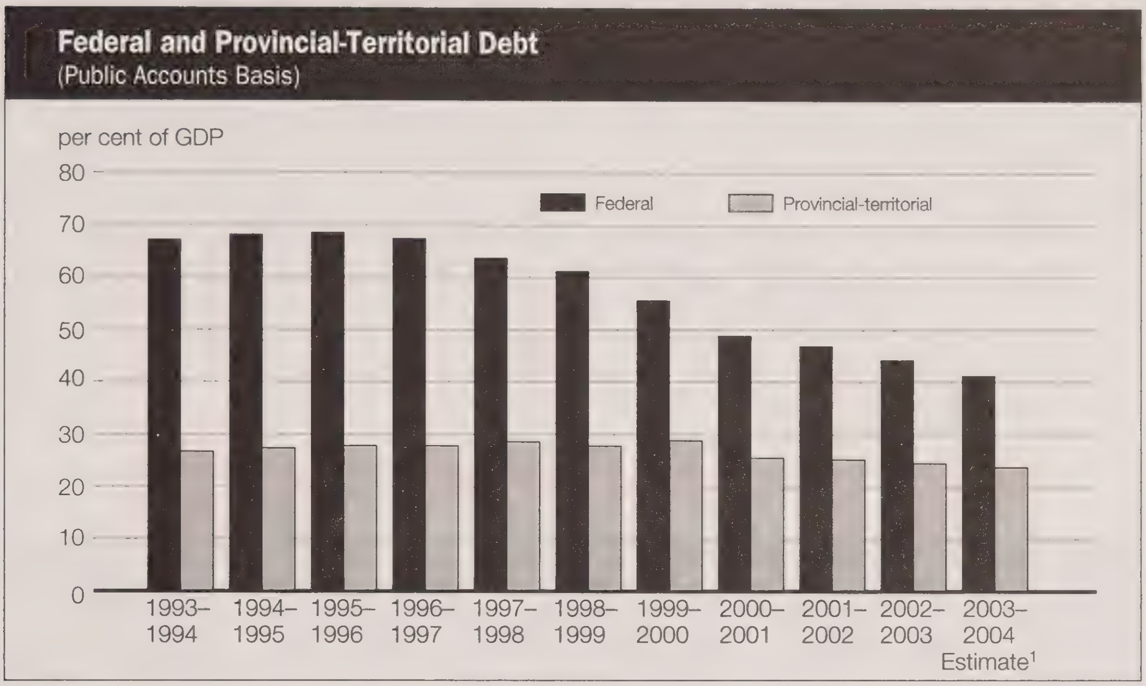
[1] Estimate for 2003–04 is for provincial-territorial budgetary balances and the aggregate.
Sources: Federal and provincial-territorial Public Accounts and budgets.

- Both the federal and provincial-territorial governments have contributed to the significant turnaround in Canada's fiscal situation over the last 10 years. However, since 2002–03 the provincial-territorial sector has returned to a deficit position. In 2003–04 the provincial-territorial deficit is estimated to be $3.8 billion. This is expected to improve significantly this year and beyond.

- The federal-provincial-territorial surplus is estimated at $5.3 billion for 2003–04, which represents a significant improvement from 1993–94, when the sector posted a $58.9-billion deficit.

- The commitment to balanced budgets or better at the federal level combined with an improving provincial-territorial outlook, particularly in light of recent increases in federal transfers, suggest that Canada's fiscal situation will remain strong.

The debt burden continues to fall across both orders of government



[1] Estimate for 2003–04 is for provincial-territorial debt only.

Sources: Federal and provincial-territorial Public Accounts and budgets.

- The provincial-territorial debt-to-GDP ratio is expected to be 23.6 per cent in 2003–04, a decline of 5.1 percentage points from its peak of 28.7 per cent in 1999–2000.

- The federal debt burden remains much higher than the combined provincial-territorial debt burden. As a result, the federal government continues to face much higher debt-servicing charges than the provincial-territorial sector.

Canada's Fiscal Performance: An International Perspective

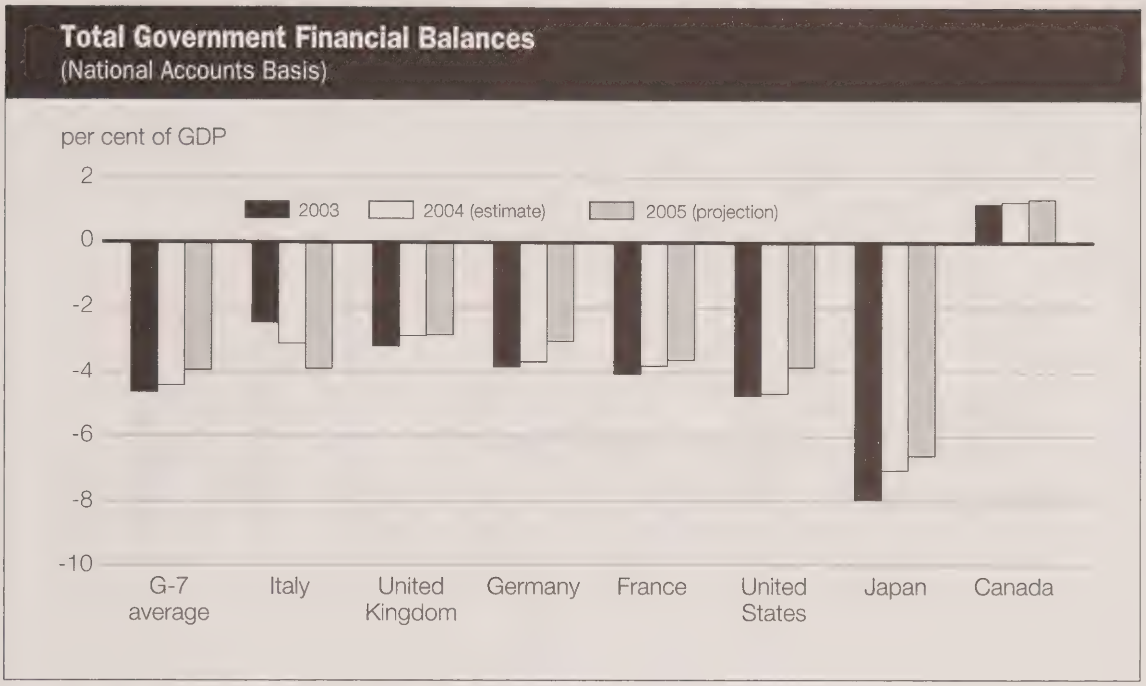
Comparing Fiscal Results Across Countries

- Two important factors need to be taken into account in making international comparisons: differences in accounting methods among countries which affect the comparability of data, and differences in financial responsibilities among levels of government within countries.
- For these reasons, the standardized System of National Accounts definitions and data are used, and the focus is the total government sector (i.e., the combined national and subnational levels) when making comparisons across G-7 countries. The Organisation for Economic Co-operation and Development (OECD) produces a complete series of estimates based on this system. Unless otherwise indicated, the data presented in this annex are based on the June 2004 *OECD Economic Outlook*.

Comparing Fiscal Results Between the Canadian and U.S. Federal Governments

It is also important to note that there are certain fundamental differences in the accounting practices and responsibilities of the Canadian and U.S. federal governments. The U.S. federal budgetary balance includes the substantial surpluses in the social security system, whereas surpluses in the Canada Pension Plan are not included in the Canadian federal figures. For this reason, the Canadian federal balance is more comparable with the "on-budget" balance in the U.S., while U.S. government debt is more comparable with federal market debt in Canada.

Canada is again expected to be the only G-7 country to record a surplus in 2004 and 2005



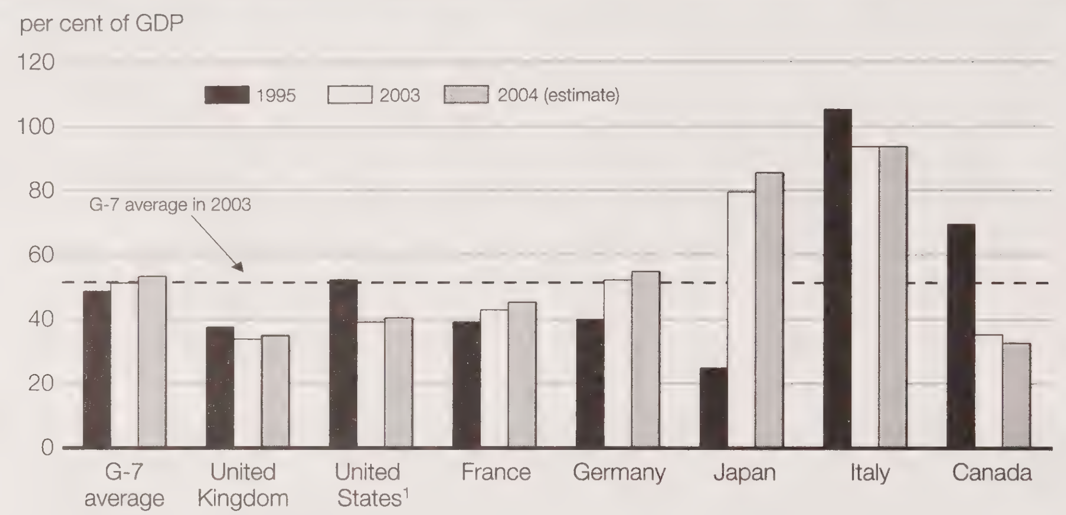
Source: *OECD Economic Outlook,* No. 75 (June 2004).

- In 2003, on a total government basis,[1] Canada was the only G-7 country to post a surplus. This was the second consecutive year that Canada was the only G-7 country in surplus.
- This was also the seventh consecutive year that Canada has been in surplus on this basis—the only G-7 country to have recorded seven consecutive surpluses since 1960, the first year for which comparable international fiscal statistics are available from the OECD.
- Canada is expected to continue to be the only G-7 country in surplus again in 2004, according to OECD estimates of the total government sector financial position.
- The OECD also expects that this will continue in 2005.

[1] Includes federal, provincial-territorial and local governments as well as the Canada Pension Plan and Quebec Pension Plan, measured on a National Accounts basis. The OECD uses the term "financial balance" to mean "budgetary balance."

Canada is expected to have the lowest debt burden among the G-7 countries in 2004

Total Government Net Financial Liabilities
(National Accounts Basis)



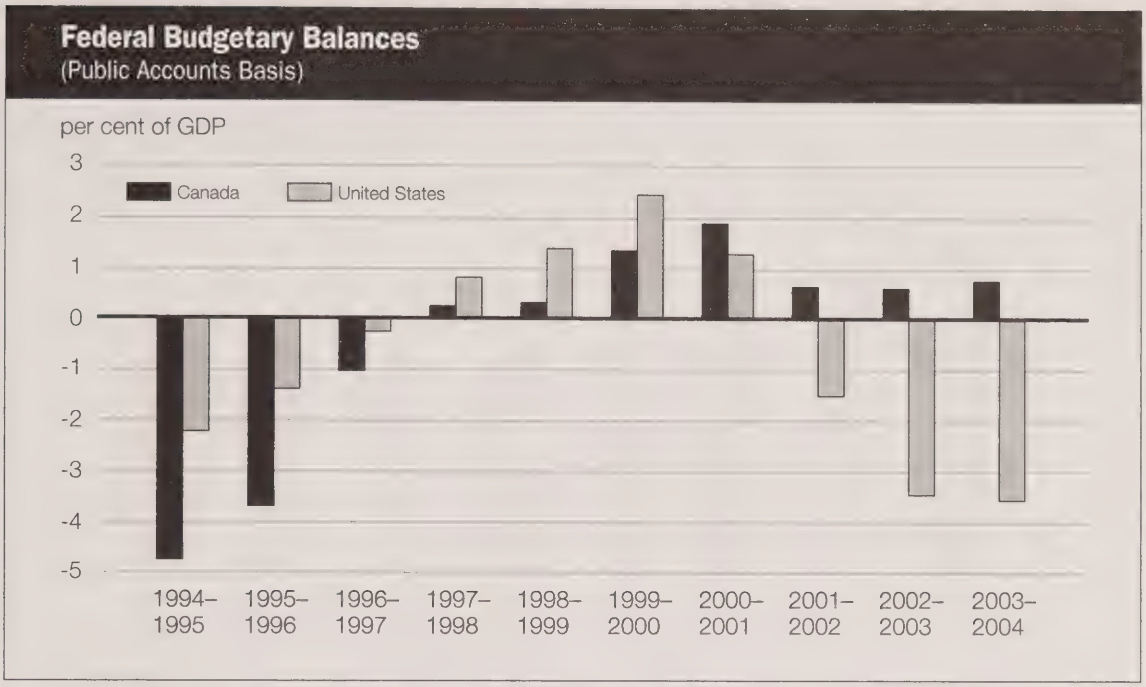
[1] Adjusted to exclude certain government employee pension liabilities to enhance comparability with other countries' debt measures.

Sources: *OECD Economic Outlook*, No. 75 (June 2004); Federal Reserve, *Flow of Funds Accounts of the United States* (June 2004); Department of Finance calculations.

- Between 1995 and 2003, Canada's ratio of total government net financial liabilities to GDP was reduced by 34.4 percentage points, to 34.9 per cent of GDP. This is Canada's lowest debt burden on a total government basis in nearly 20 years.

- As a result, Canada is projected by the OECD to have gone from having the second highest total government debt burden among G-7 countries in the mid-1990s to having the lowest debt burden among G-7 countries by the end of 2004. This would be the first time since the OECD started publishing these estimates in 1960 that Canada's debt burden would be the lowest among the G-7 countries.

Unlike the U.S., the federal government in Canada has maintained a budgetary surplus since 1997–98



Note: This chart shows the federal budgetary balance for Canada and unified budget balance for the U.S. for fiscal years ending March 31 and September 30 respectively.

Sources: Canada—Department of Finance; U.S.—Department of the Treasury and Office of Management and Budget.

- The improved federal fiscal situation in Canada is in stark contrast to recent developments in the United States at the federal level. Like Canada, the U.S. federal government achieved a significant turnaround in its budgetary balance in the second half of the 1990s, moving from large deficits to surpluses. However, since 2001–02 Canada has remained in surplus while the U.S. has returned to large deficits.

- The Canadian federal government posted a surplus of C$9.1 billion, or 0.7 per cent of GDP, in 2003–04, while the U.S. government incurred a record deficit of US$413 billion, or 3.6 per cent of GDP. Moreover, the U.S. government's "on-budget" deficit,[2] which is more directly comparable to the Canadian federal balance, was US$568 billion or 4.9 per cent of GDP.

- While a balanced budget or better is expected for Canada in 2004–05, a very large U.S. budget deficit is expected.

[2] The U.S. "on-budget" balance is more comparable with the Canadian federal budget balance because it excludes the pension surpluses of the U.S. social security system. The balance of the Canada Pension Plan is not included in the Canadian federal budget balance figures.

The federal market debt-to-GDP ratio in Canada fell below that of the U.S. in 2003–04

Note: This chart shows federal market debt for Canada and federal debt held by the public for the U.S. for fiscal years ending March 31 and September 30 respectively. These two measures are the most comparable measures of the federal debt burden across the two countries.

Sources: Canada—Department of Finance; U.S.—Department of the Treasury and Office of Management and Budget.

- As a result of continued surpluses at the federal level in Canada and the recent deterioration in U.S. federal finances, the federal market debt-to-GDP ratio in Canada fell below the U.S. figure in 2003–04 for the first time since 1977–78.
- The Canadian federal market debt-to-GDP ratio fell to 36.1 per cent in 2003–04, while the U.S. figure rose for the third consecutive year to 37.3 per cent.
- This gap is expected to widen in coming years.

Annex 2

Economic Developments and Prospects[1]

[1] This annex incorporates data available up to November 5, 2004. Figures are at annual rates unless otherwise noted.

Highlights

- *World economic growth strengthened in 2004, as growth picked up in the United States, the Euro area and Japan. U.S. economic growth slowed in the second quarter of 2004, but advance estimates indicate that growth picked up in the third quarter, and solid growth is forecast for next year.*

- *Economic growth in Canada rebounded strongly in 2004 following a series of shocks in 2003. The resilience of the Canadian economy reflects Canada's strong fiscal, monetary and structural framework.*

- *Renewed strong job creation since late 2003, particularly in full-time positions, has supported high levels of consumer confidence, consumer spending and residential investment.*

- *Investment in machinery and equipment has remained healthy, thanks in part to rapid profit growth. This should help Canada maintain the improved productivity and living standards growth achieved since 1997.*

- *The record appreciation of the Canadian dollar took its toll on exports throughout much of 2003. However, export growth rebounded faster than expected in the first half of 2004 as exporters demonstrated their continued ability to compete in the international marketplace.*

- *Private sector forecasters expect solid growth in 2004 and 2005. Based on the September Department of Finance survey of private sector forecasters and further consultations with forecasters in early November, growth is expected to be 3.0 per cent in 2004, somewhat higher than the 2.7 per cent expected at the time of the March 2004 budget. For 2005, private sector forecasters expect growth of 3.2 per cent.*

- *Private sector forecasters now expect nominal gross domestic product (GDP) in 2004 to be $29.5 billion higher than they expected at the time of the 2004 budget. Their nominal GDP forecast for 2005 has been revised up by $33.9 billion.*

- *Despite the encouraging growth outlook for the Canadian and global economies, there remain significant, mainly external, risks to the Canadian outlook.*

- *High oil prices pose a downside risk to the global economy. High energy prices reduce the purchasing power of oil consumers around the world, dampening exports and also reducing consumer spending in Canada. However, higher oil prices stimulate investment and production in the Canadian energy sector, which positively affects growth.*

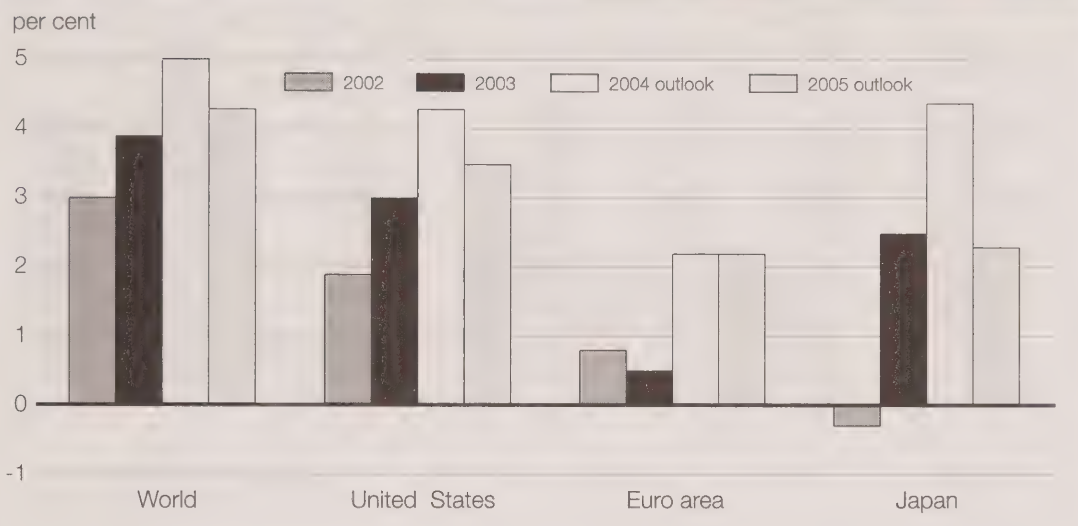
- *The appreciation of the Canadian dollar since the beginning of 2003 stems from higher commodity prices and ongoing adjustments to global current account imbalances. The possibility of further exchange rate adjustments to resolve these imbalances poses a risk to the outlook. While the timing and magnitude of the adjustments are uncertain, the relatively quick recovery from the 2003 appreciation of the Canadian dollar suggests that any impact could be short-lived.*

- *Over the medium term, resolution of the U.S. fiscal imbalance remains the principal downside risk. A serious effort to reduce the fiscal deficit would temporarily lower U.S. demand, placing downward pressure on Canadian exports to the U.S. However, if uncorrected, rising government debt could put upward pressure on interest rates, crowding out investment and dampening growth in the U.S.*

World Economic Conditions

Global economic activity has strengthened in 2004 and forecasters expect robust growth in 2005

World Real GDP Growth



Source: International Monetary Fund, *World Economic Outlook* (September 2004).

- Despite higher world energy prices, the global recovery has become increasingly well established, thanks to accommodative monetary and fiscal policies, rising corporate profitability and healthy business investment. In its September *World Economic Outlook*, the International Monetary Fund (IMF) forecasts world real GDP growth will reach 5.0 per cent in 2004, the highest growth rate in nearly three decades. World growth is projected to moderate to a still-strong 4.3 per cent in 2005.

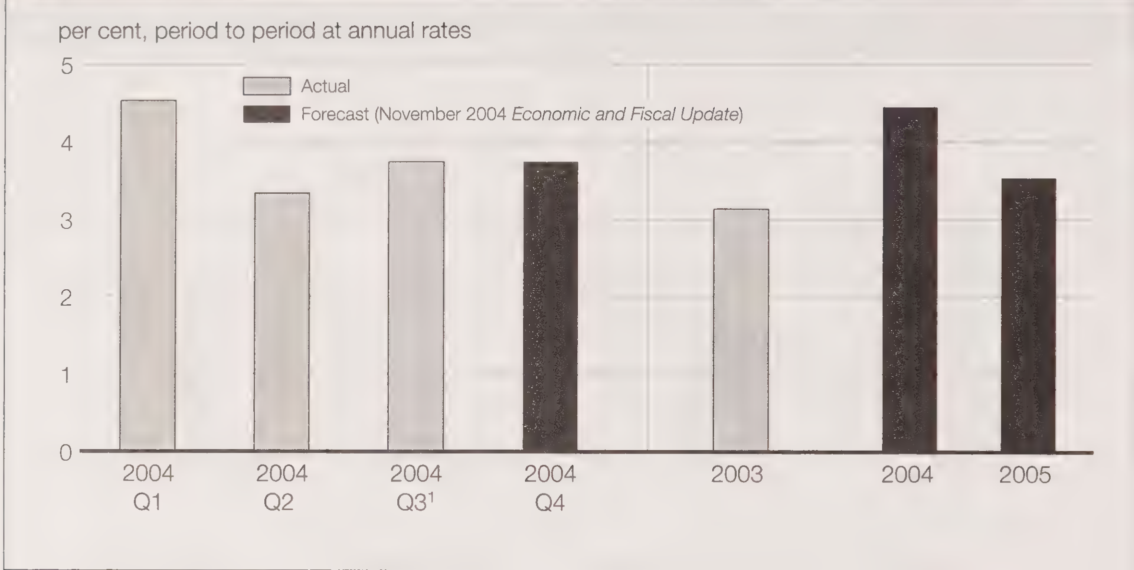
- The economic situation in Japan improved markedly in 2004, thanks to healthy business investment and strong demand from China for Japanese exports. Despite a deceleration in the second half of the year, real GDP growth in Japan is expected to exceed 4 per cent in 2004, before falling back to just over 2 per cent in 2005.

- China is expected to grow at an impressive pace through the rest of 2004, driven mostly by abundant foreign direct investment. Growth is expected to gradually decelerate in 2005, partly in response to government policies aimed at easing growth to more sustainable levels. Strong growth in China has helped stimulate not only Japan, but other Asian economies such as Korea and Singapore.

- Growth in the Euro area appears to have regained some momentum recently. Growth is expected to reach 2.2 per cent in both 2004 and 2005. While the recovery is gradually gaining a firmer footing, it remains relatively uneven across the Euro area countries.

The outlook for the U.S. economy remains solid

U.S. Real GDP Growth



[1] Advance estimate.

Sources: Bureau of Economic Analysis and *Blue Chip Economic Indicators* (October 2004).

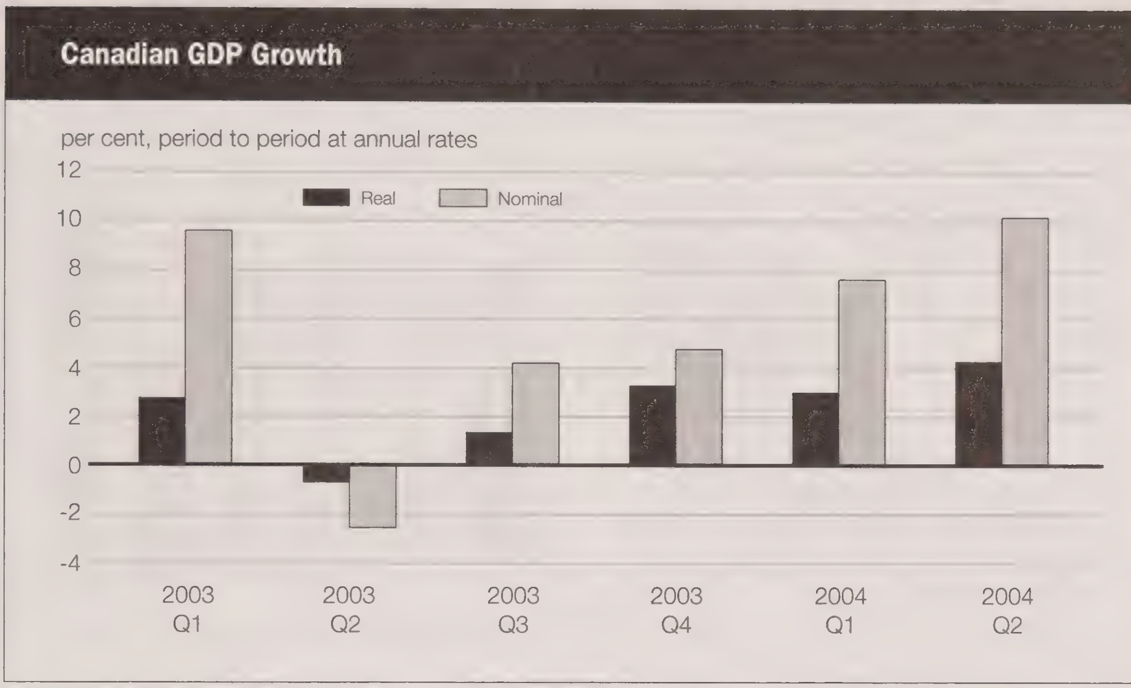
- After strong growth of 4.5 per cent in the first quarter of 2004, U.S. real GDP growth slowed to 3.3 per cent in the second quarter, but then picked up again to 3.7 per cent in the third quarter according to advance estimates. Movements in growth in recent quarters have largely stemmed from swings in consumer spending, as business investment has posted strong gains throughout 2004.

- Going forward, business investment is expected to continue to be an important driver of growth, boding well for Canadian exports of machinery and equipment. The continued impact of high oil prices and the waning effects of last year's tax cuts suggest that growth in consumer spending will be modest, although the recent improvement in the U.S. labour market, if sustained, will help support spending in this sector.

- Private sector forecasters expect the U.S. economy to grow by 4.4 per cent in 2004 and 3.5 per cent in 2005, slightly below expectations at the time of the March budget.

Canadian Economic Developments

The Canadian economy rebounded strongly from a series of shocks in 2003



Source: Statistics Canada.

- The Canadian economy has once again demonstrated remarkable resilience, rebounding sharply after a series of shocks in 2003, including the severe acute respiratory syndrome (SARS) outbreak, the discovery of a case of bovine spongiform encephalopathy (BSE) in Alberta and, in particular, the unprecedented appreciation of the Canadian dollar.

- Following the 2001 global slowdown, Canada outpaced the U.S. and other Group of Seven (G-7) countries in both GDP and employment growth.

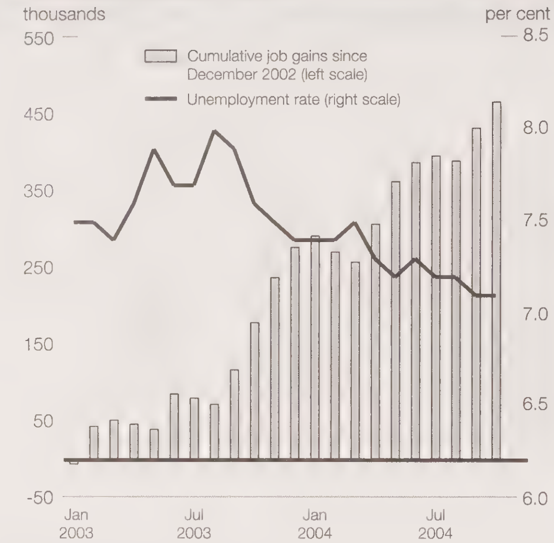
- After slowing in mid-2003, real GDP growth strengthened to 3.3 per cent in the last quarter of 2003. Real GDP grew by 3.0 per cent in the first quarter of 2004, spurred by strong advances in domestic demand.

- In the second quarter, helped by surging exports, growth accelerated to 4.3 per cent, well above the 3.3 per cent recorded in the U.S.

- Nominal GDP rebounded even more strongly in 2004, growing 7.6 per cent in the first quarter and 10.2 per cent in the second.

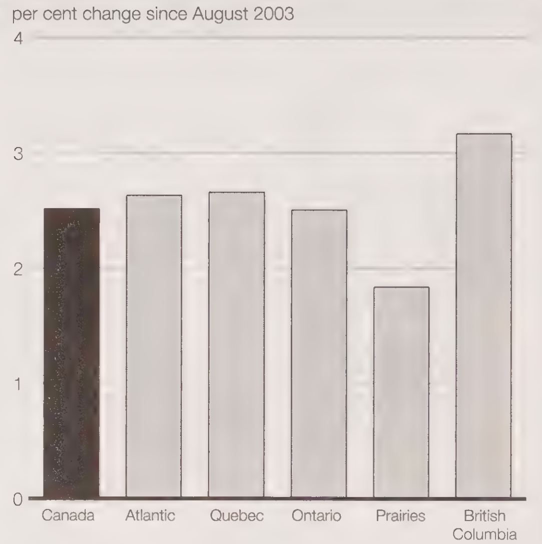
Robust employment growth has resumed in all regions

Employment and the Unemployment Rate



Source: Statistics Canada.

Employment by Region



Source: Statistics Canada.

- The series of shocks that hit the economy in 2003 slowed employment growth and pushed the unemployment rate to a high of 8.0 per cent in August of last year.
- However, robust job growth resumed in September 2003. Since August 2003 the economy has created nearly 400,000 jobs, all of which are full-time positions. The 2.5-per-cent increase in Canadian employment is well above the 1.7-per-cent increase recorded in the United States over the same period.
- With strong job creation in Canada, the unemployment rate fell steadily—despite near record rates of participation in the labour market—and stood at 7.1 per cent in October 2004, a rate not seen since mid-2001.
- Employment growth has been broadly shared across the provinces since August 2003, with each region recording significant growth.

Increased employment has supported healthy income growth and high levels of consumer confidence

Real Personal Disposable Income Per Capita

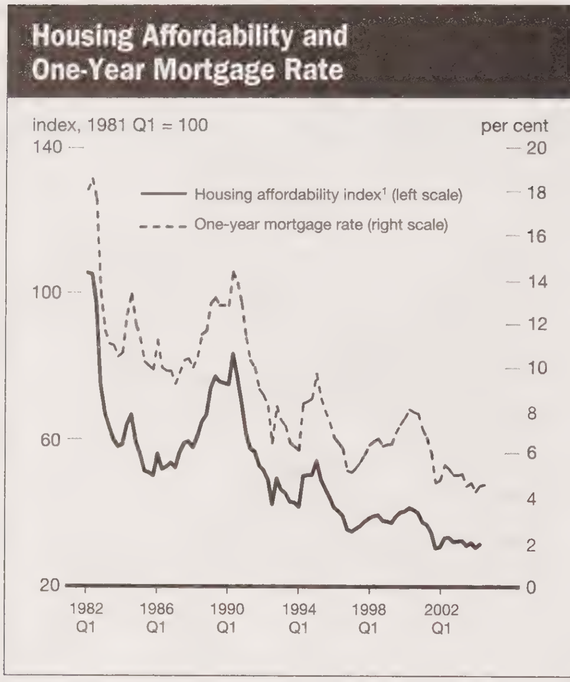
Sources: Statistics Canada and Department of Finance calculations.

Index of Consumer Attitudes

Source: Conference Board of Canada.

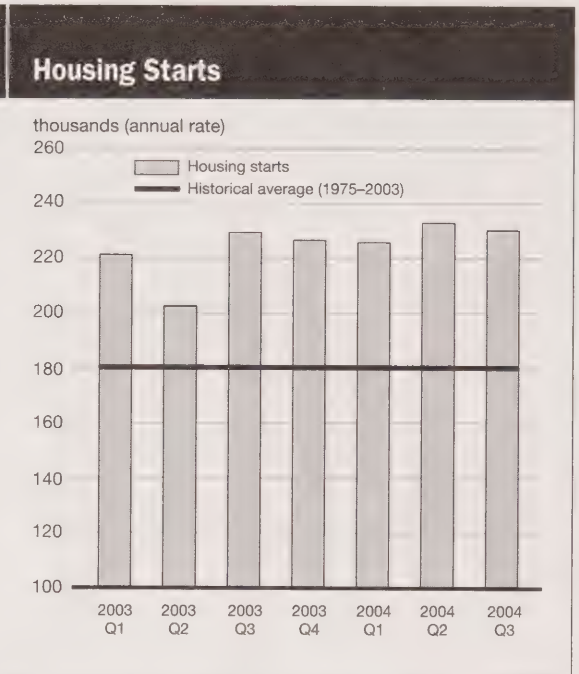
- The strong pace of job creation, particularly in full-time positions, has supported income growth and pushed consumer confidence well above historical averages in all regions of the country.
- In the first half of 2004 real personal disposable income per capita rose 3.3 per cent relative to the second half of 2003. Real consumer spending also increased a strong 3.7 per cent over the same period thanks to rising income, high consumer confidence and historically low interest rates.

Historically low borrowing costs have continued to improve housing affordability and support housing activity



[1] Using one-year mortgage rate.

Sources: Statistics Canada and Department of Finance.



Source: Canada Mortgage and Housing Corporation.

- Low interest rates, as well as rising disposable income due to healthy employment growth, have improved housing affordability, which was near its best level on record in the second quarter.

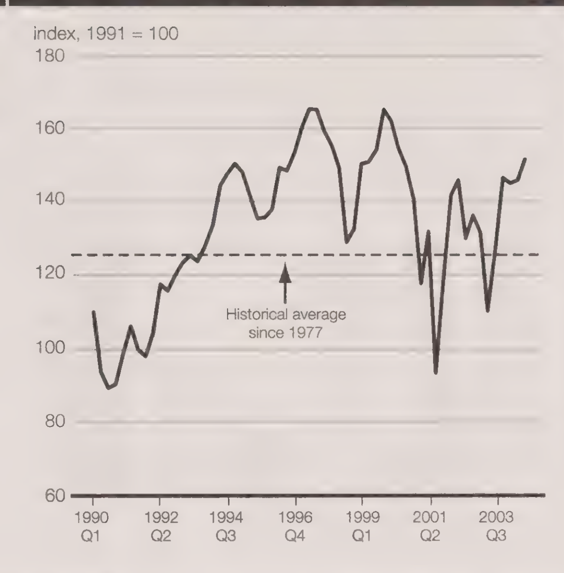
- These factors have supported continued robust growth in real business residential investment, which stood at 9.6 per cent in the first half of 2004. Housing starts reached an annualized average of over 229,000 in the first nine months of the year—the highest level in 17 years and well above the historical average of about 180,000.

Corporate profits have reached near record levels, thanks in part to rising commodity prices

Corporate Profits

Source: Statistics Canada.

Index of Business Confidence



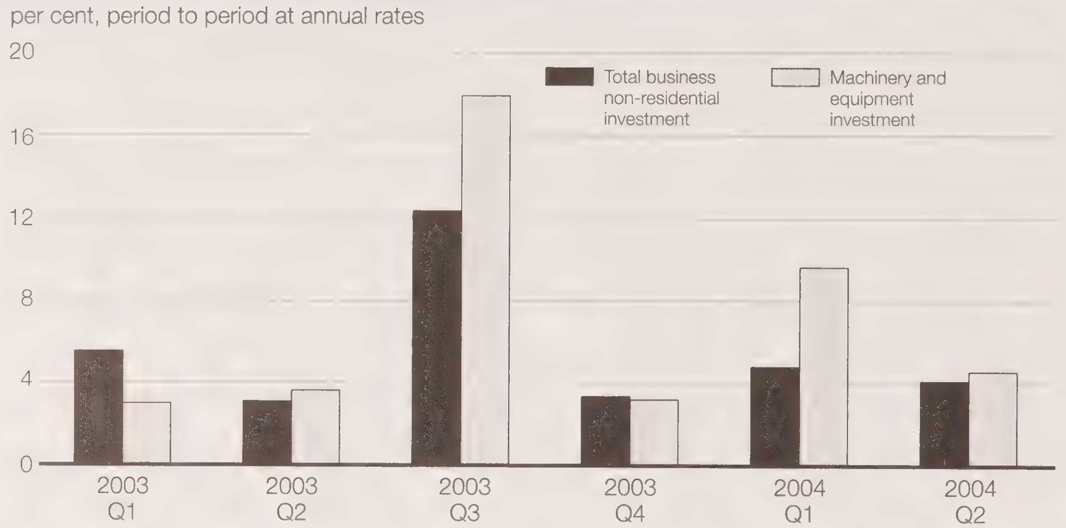
Source: Conference Board of Canada.

- Corporate profits rose 28.5 per cent in the first half of 2004, and the gain was broadly based. For example, oil and gas firms benefited from higher prices and strong international demand. Wood and paper manufacturers also saw increased profits as strong North American demand for housing boosted the price of wood and paper prices picked up. Currently total corporate profits in Canada stand at 13.8 per cent of GDP, the highest level in 30 years.

- Reflecting in part the strength in profits, business confidence remains at a high level—more than half of firms surveyed by the Conference Board of Canada in the third quarter believe that their financial position and their profitability will improve over the next six months.

Businesses continue to invest at a healthy pace, particularly in machinery and equipment

Real Business Non-Residential Investment Growth



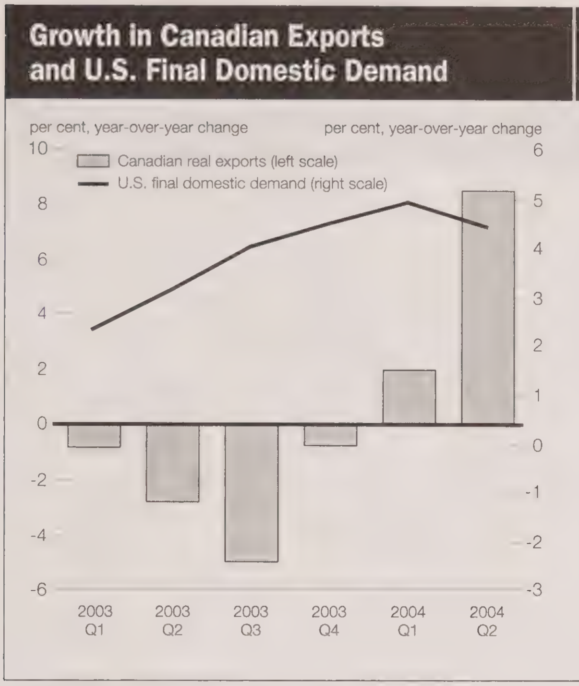
Source: Statistics Canada.

- The strength in corporate profits and business confidence has supported business non-residential investment, which rose by a solid 4.1 per cent in the second quarter of 2004, the sixth consecutive increase.

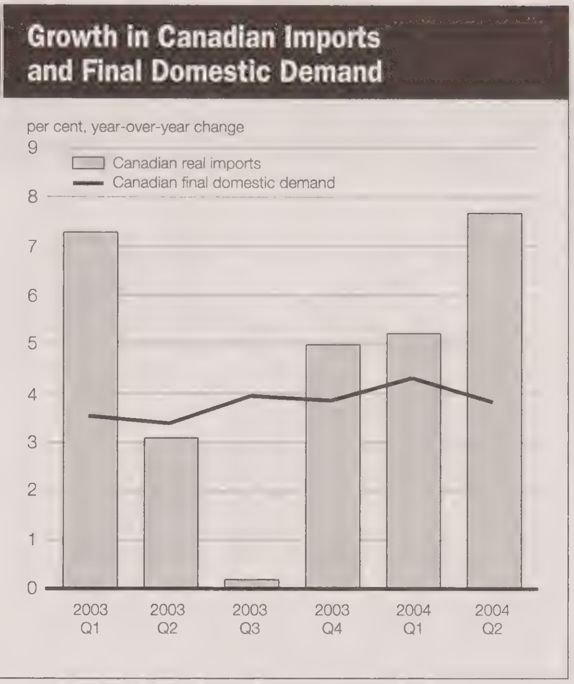
- High energy prices have encouraged engineering construction in the oil and gas sector, which in turn contributed to a rebound in non-residential construction in the second quarter.

- Investment in machinery and equipment (M&E) increased 4.5 per cent in the second quarter after growing by nearly 10 per cent in the first, helped by the stronger Canadian dollar, which has made imported M&E more affordable. This growth in investment in M&E should support further gains in productivity, a key factor in raising Canadian living standards over the long run.

Exports were affected by the dollar's rapid increase in 2003 but rebounded sharply in 2004...



Sources: Statistics Canada and Bureau of Economic Analysis.



Source: Statistics Canada.

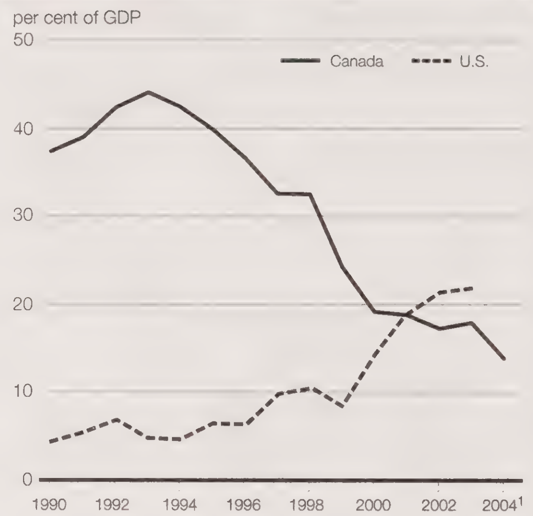
- Despite strong growth in U.S. demand, Canadian exports fell in 2003, in part because of the rapid and sizeable appreciation of the Canadian dollar.
- However, during the first half of 2004 exports rebounded, reflecting stronger external demand and the ability of Canadian businesses to adjust quickly to changing economic conditions.
- On the import side, the stronger Canadian dollar, along with continued strength in Canadian domestic demand, contributed to sustained growth in imports over much of 2003 and the first half of 2004.

...contributing to near record current account surpluses and further reductions in Canada's net foreign debt

Current Account Balance

[1] First two quarters annualized.
Sources: Statistics Canada and Bureau of Economic Analysis.

Net Foreign Debt



[1] For Canada, first two quarters annualized.
Sources: Statistics Canada and Bureau of Economic Analysis.

- Recent robust growth in exports has been complemented by favourable movements in the terms of trade—prices of exports relative to prices of imports—reflecting, in part, higher commodity prices. As a result, Canada's current account surplus rose to nearly $42 billion in the second quarter of 2004—the second highest on record and the 20th consecutive quarterly surplus.

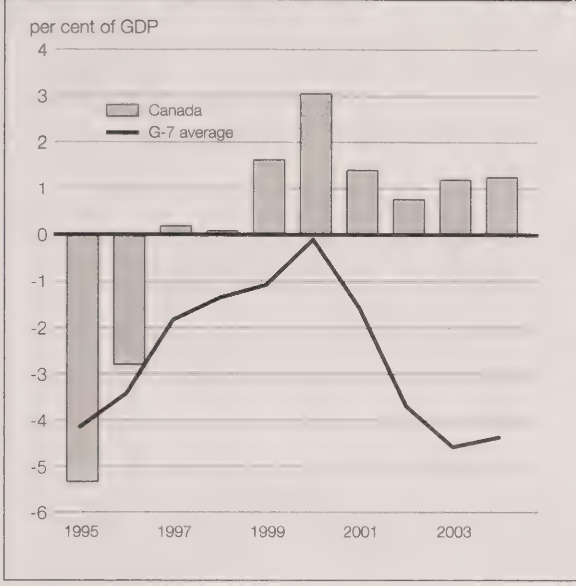
- Ongoing current account surpluses have generated a sustained reduction in Canada's net foreign debt as a share of GDP, which stood at 13.7 per cent in the second quarter of 2004, the lowest level in almost 50 years. This means that more of the income that Canadians earn is staying in Canada.

- These developments stand in stark contrast to the U.S., where large current account deficits have raised net foreign debt to over 20 per cent of GDP.

Canada's Macroeconomic and Structural Framework

Canada has the most favourable fiscal position among G-7 countries

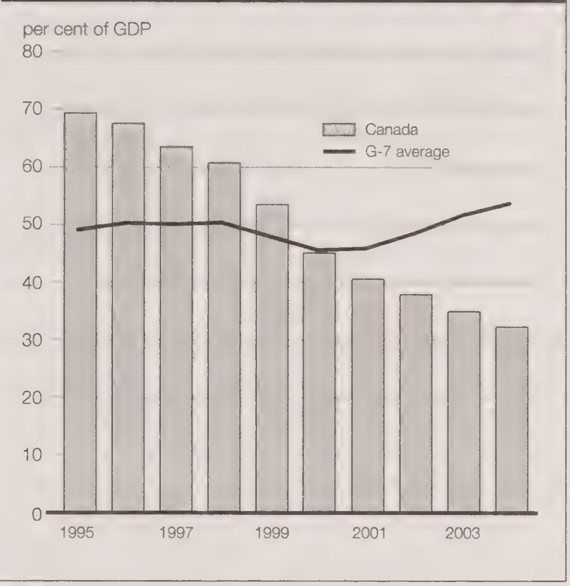
Total Government Financial Balances (National Accounts Basis)



Note: 2004 is an estimate.

Sources: *OECD Economic Outlook*, No. 75 (June 2004); Statistics Canada; Department of Finance calculations for the G-7 average.

Total Government Net Financial Liabilities (National Accounts Basis)



Note: 2004 is an estimate.

Sources: *OECD Economic Outlook*, No. 75 (June 2004); *Flow of Funds Accounts of the United States* (September 2004); Department of Finance calculations.

- Canada's improved ability to weather economic shocks is driven in large part by reforms to the macroeconomic and structural environment that were implemented over the last decade. According to the Organisation for Economic Co-operation and Development (OECD), "the Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well designed macroeconomic framework and the pay off from a range of structural reforms implemented since the late 1980s."[2]

- In the early 1990s Canada's total government deficit was larger than the average of G-7 countries. However, significant fiscal improvements at all levels of government enabled Canada's total government sector to post a surplus in 1997. In 2003 Canada's total government sector recorded a surplus of 1.2 per cent of GDP, compared to the average G-7 deficit-to-GDP ratio of 4.6 per cent. Canada's fiscal turnaround is unmatched by any other G-7 country.

[2] OECD, Economic and Development Review Committee, *Economic Survey of Canada* (October 2004).

- According to the OECD, Canada is the only G-7 country expected to post a total government budget surplus in 2004 and 2005, and the IMF calls Canada's fiscal position the "most favourable among G-7 countries."[3]

- Canada's total government debt burden moved from being the second highest in the G-7 in 1998 to the second lowest in 2003. Canada's total government sector net financial liabilities stood at 34.9 per cent of GDP in 2003, compared to the average G-7 ratio of 51.1 per cent.

- A strong fiscal position has allowed the Government of Canada to deliver significant tax relief to all Canadians, enhancing incentives to work, save and invest, while also creating a tax advantage for Canadian businesses and entrepreneurs vis-à-vis the United States, without risking a return to deficits.

- As well, the Government has been able to make significant investments in important economic and social priorities.

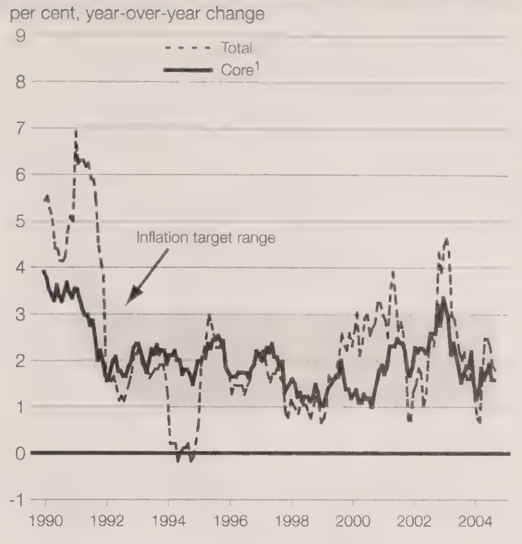
- Since balancing the budget, the Government has invested substantial resources in research and development and knowledge creation, which support stronger economic growth and a higher quality of life.

- A wide range of government initiatives help the Canadian workforce become increasingly well-educated, adaptable and skilled, while measures in support of low- and modest-income families improve the chance that Canadian children will grow up to be healthy, contributing members of society.

[3] IMF, *World Economic Outlook* (September 2004).

More than a decade of low and stable inflation, together with fiscal discipline, has contributed to lower interest rates

Total and Core Inflation



[1] Core Consumer Price Index (CPI) inflation is the all-items CPI excluding the eight most volatile components as well as the effect of changes in indirect taxes on the remaining components.

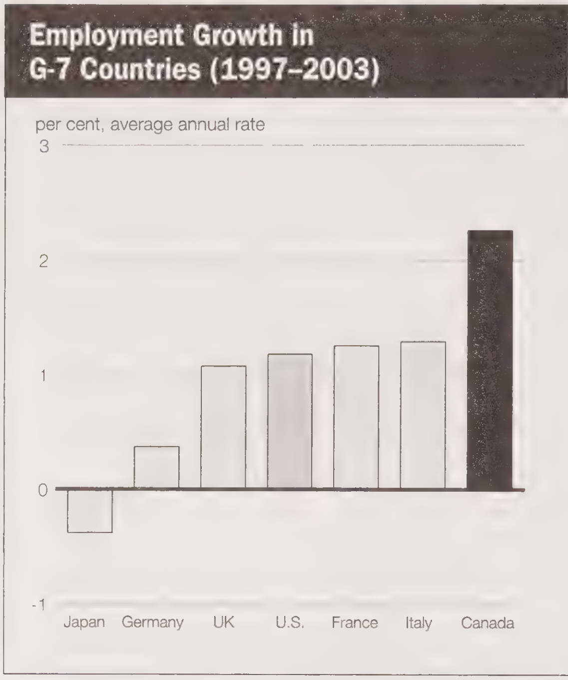
Source: Statistics Canada.

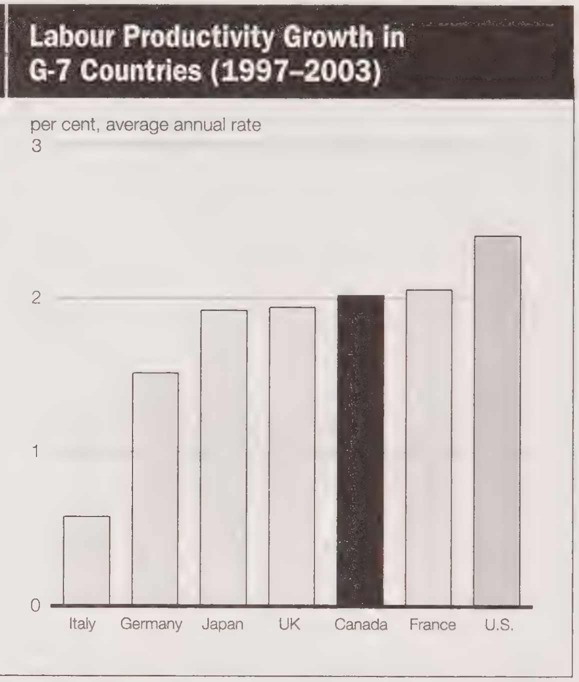
Three-Month Treasury Bill Rate

Source: Statistics Canada.

- The credibility of Canada's monetary policy, achieved through more than a decade of low and stable inflation, has complemented reform on the fiscal front.
- Since 1993 inflation in Canada has averaged 1.8 per cent—very close to the mid-point of the current inflation-targeting range of 1 to 3 per cent agreed upon by the Bank of Canada and the Government of Canada.
- Low and stable inflation, together with a strong fiscal position, gives the Bank of Canada the flexibility to respond quickly and decisively to changing economic conditions.
- Furthermore, by eliminating the deficit and moving to sustained fiscal surpluses after 1997, Canada has improved its international fiscal credibility, restoring its triple-A rating in financial markets, which in turn has led to reductions in risk premiums and interest rates.
- Lower interest rates have reduced the debt burden, freeing up resources to fund the priorities of Canadians and providing strong support to interest-sensitive sectors, such as housing, consumer expenditures and business investment.

Sound fiscal and monetary policies have contributed to renewed employment and productivity growth...

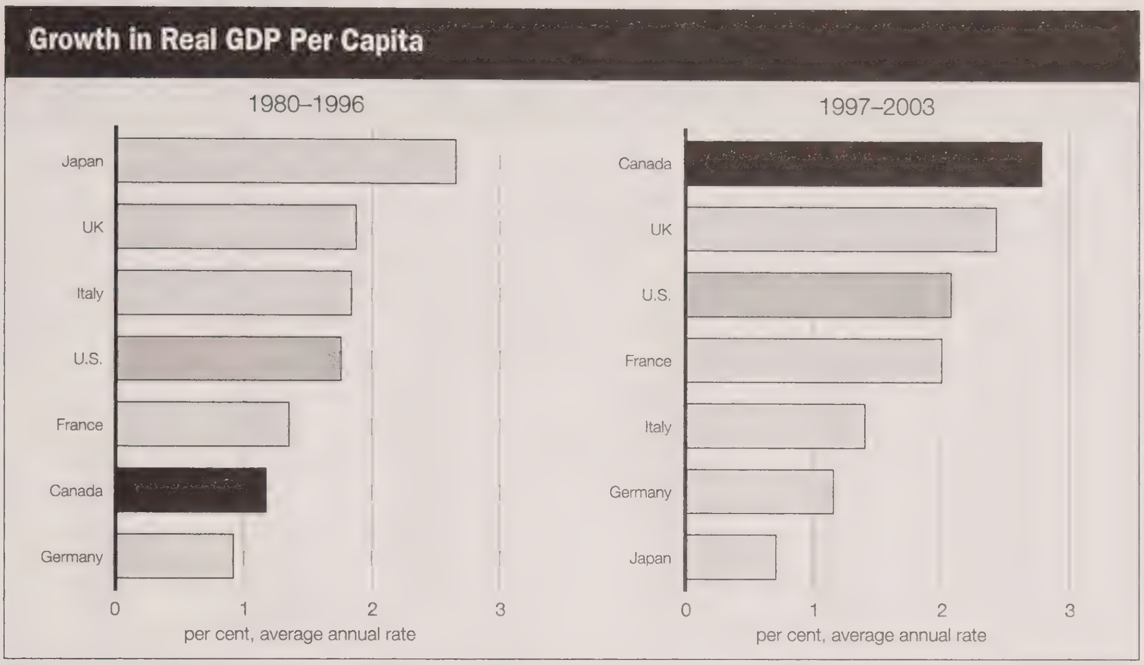




Sources: Canada—Statistics Canada; United States—Bureau of Economic Analysis and Bureau of Labor Statistics; rest of G-7—*OECD Economic Outlook*, No. 75 (June 2004).

- Improved fiscal and monetary policies have created the conditions for stronger growth in employment and productivity, two factors which have driven strong gains in Canadian living standards since 1997.
- Canada achieved exceptionally strong employment growth between 1997 and 2003—by far the best in the G-7 and nearly double the pace recorded in the U.S. Over the same period, productivity growth improved noticeably following a period of lacklustre growth during the 1980s and early 1990s.
- As the population ages, it will be increasingly difficult to improve living standards through increased employment because of the shrinking size of the working-age population. Instead, Canada must increasingly rely on productivity growth.

...and have laid the foundation for a sustained improvement in Canadian living standards



Sources: Canada—Statistics Canada; United States—Bureau of Economic Analysis and Bureau of Labor Statistics; rest of G-7—*OECD Economic Outlook*, No. 75 (June 2004).

- Between 1980 and 1996 Canada ranked second last among the G-7 countries in growth in real GDP per capita, the most commonly used measure of average living standards.

- However, thanks to stronger employment and productivity growth, Canada recorded the strongest growth in living standards among all G-7 countries between 1997 and 2003. The average standard of living of Canadians increased more in the past 7 years than in the previous 17.

Private Sector Economic Forecasts

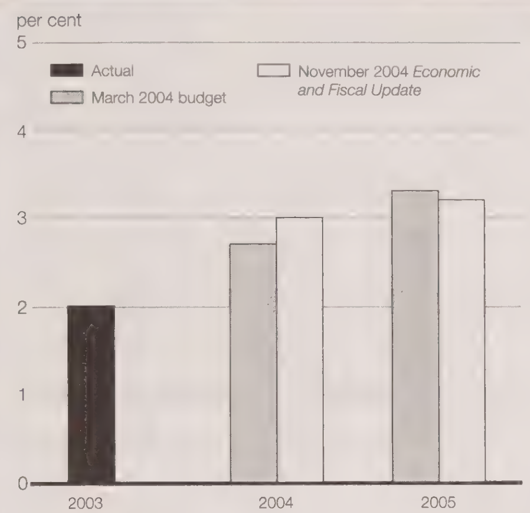
- The Department of Finance surveys about 20 private sector economic forecasters on a quarterly basis regarding their outlook for the Canadian economy. The Minister of Finance, along with departmental officials, also meets with a group of private sector economists to discuss risks and uncertainties associated with the outlook.

- The economic forecasts reported here reflect the survey of private sector forecasters conducted by the Department following the release of the second-quarter National Accounts by Statistics Canada on August 31 and further consultations with private sector forecasters in early November. The Department's survey of private sector forecasters is the basis for the economic assumptions that underlie the five-year status quo fiscal projections provided in Annexes 3 and 4.

The Canadian Economic Outlook

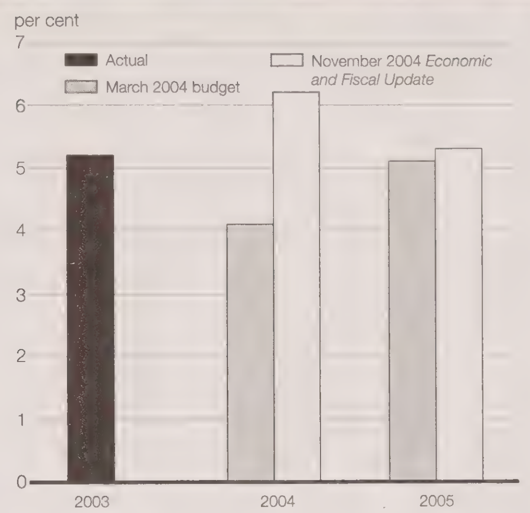
Private sector forecasters expect improved economic growth in Canada for 2004 and 2005

Real GDP Growth



Sources: Statistics Canada, March 2004 and September 2004 Department of Finance surveys of private sector forecasters and further consultations with private sector forecasters in early November.

Nominal GDP Growth



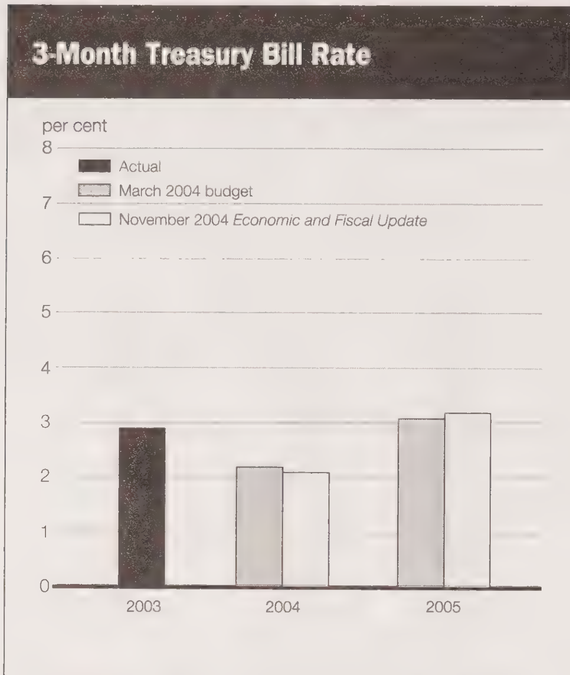
Sources: Statistics Canada, March 2004 and September 2004 Department of Finance surveys of private sector forecasters and further consultations with private sector forecasters in early November.

- Private sector forecasters expect real GDP to grow by 3.0 per cent in 2004, up from 2.7 per cent at the time of the March 2004 budget. Growth is expected to rise to 3.2 per cent in 2005, slightly lower than the 3.3-per-cent forecast at the time of the 2004 budget. According to the IMF, Canada is expected to have the second fastest growth rate in 2005 among G-7 countries, behind only the United States.

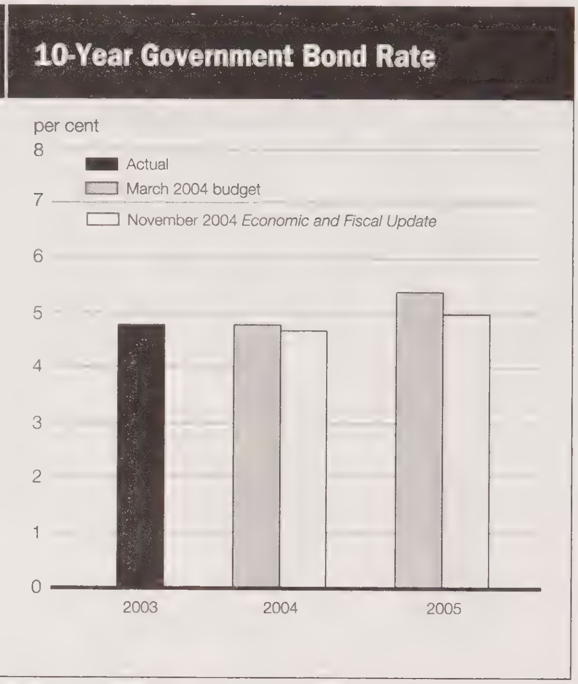
- Private sector forecasters have significantly raised their forecast for GDP inflation in 2004, reflecting much stronger-than-expected growth in commodity prices. As a result, they expect nominal GDP to grow 6.2 per cent this year and 5.3 per cent in 2005, compared to 4.1 per cent and 5.1 per cent, respectively, at the time of the 2004 budget.

- Private sector forecasters now expect nominal GDP in 2004 to be $29.5 billion higher than they expected at the time of the 2004 budget. Their nominal GDP forecast for 2005 has been revised up by $33.9 billion.

With stronger growth, private sector forecasters expect monetary stimulus to be gradually withdrawn



Sources: Statistics Canada, March 2004 and September 2004 Department of Finance surveys of private sector forecasters and further consultations with private sector forecasters in early November.



Sources: Statistics Canada, March 2004 and September 2004 Department of Finance surveys of private sector forecasters and further consultations with private sector forecasters in early November.

- Private sector forecasters expect the Bank of Canada to continue raising its target interest rate between now and the end of 2005. However, short-term interest rates have remained low in 2004 at 2.1 per cent, little changed from the time of the 2004 budget. Forecasters now expect that short-term rates in 2005 will average 3.2 per cent, slightly higher than forecast at the time of the March budget.

- Forecasters expect long-term rates to average 4.7 per cent in 2004 and 5.0 per cent in 2005, moderately lower than expected at the time of the March budget.

Private Sector Forecasts for 2004 and 2005

	2004	2005
	(per cent)	
Real GDP growth		
March 2004 budget	2.7	3.3
November 2004 *Economic and Fiscal Update*	3.0	3.2
GDP inflation		
March 2004 budget	1.4	1.7
November 2004 *Economic and Fiscal Update*	3.1	2.1
Nominal GDP growth		
March 2004 budget	4.1	5.1
November 2004 *Economic and Fiscal Update*	6.2	5.3
3-month Treasury bill rate		
March 2004 budget	2.2	3.1
November 2004 *Economic and Fiscal Update*	2.1	3.2
10-year government bond rate		
March 2004 budget	4.8	5.4
November 2004 *Economic and Fiscal Update*	4.7	5.0
Unemployment rate		
March 2004 budget	7.5	7.2
November 2004 *Economic and Fiscal Update*	7.3	7.0
Employment growth		
March 2004 budget	1.6	1.5
November 2004 *Economic and Fiscal Update*	1.7	1.6
Addendum:		
U.S. real GDP growth		
March 2004 budget	4.7	3.8
November 2004 *Economic and Fiscal Update*	4.4	3.5

Sources: March 2004 and September 2004 Department of Finance surveys of private sector forecasters and further consultations with private sector forecasters in early November. March 2004 and October 2004 *Blue Chip Economic Indicators*.

Risks and Uncertainties

Despite the solid global growth outlook, persistently high oil prices pose a downside risk

Price of Crude Oil—West Texas Intermediate

[1] Real prices are nominal prices deflated using the U.S. GDP deflator (2004 Q3 = 1.0). Prices for 2004 Q4 are based on the October 2004 price of crude oil.

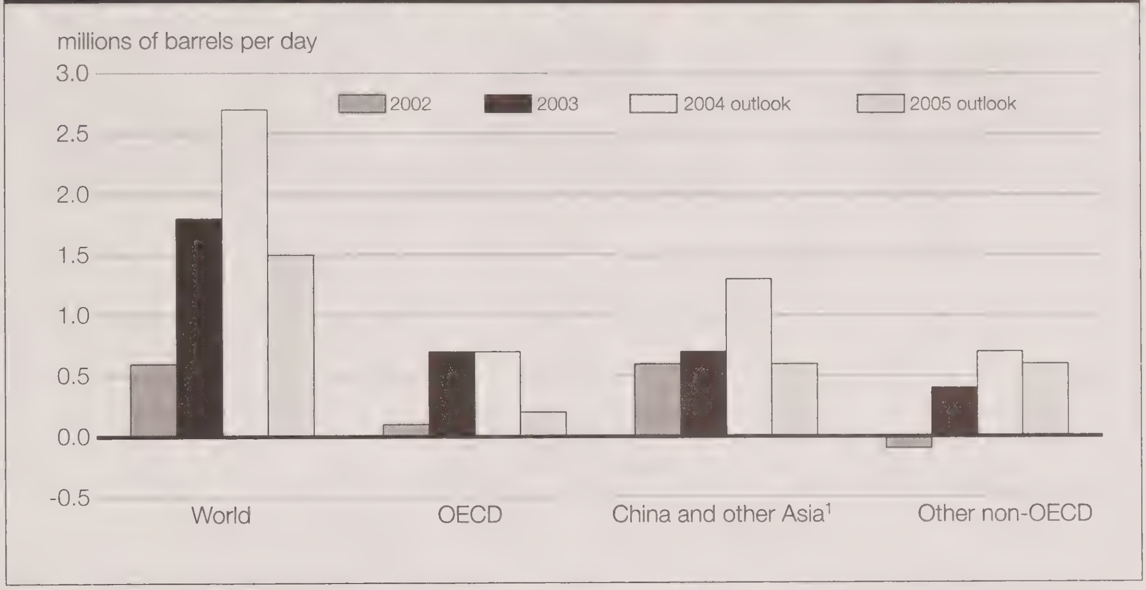
Source: Bridge Commodity Research Bureau and Bureau of Economic Analysis.

- A key risk to the global economic outlook is the path of oil prices. In October, the price of oil reached over US$55 per barrel, higher than at any time since the second oil crisis in the late 1970s. However, in real terms this remains below the historic high reached in 1980.

- If prices remain at current levels, or rise further, the global expansion could be weaker than expected. Growth would be particularly affected in oil-importing countries such as China and India, which have a higher intensity of oil use than the U.S. and Canada.

World oil demand rose considerably in 2003 and is forecast to rise further, with nearly half of the increase in 2004 coming from China and other non-OECD Asian countries

Regional Distribution of Annual Change in World Oil Demand



[1] Other Asia excludes Asian OECD countries.

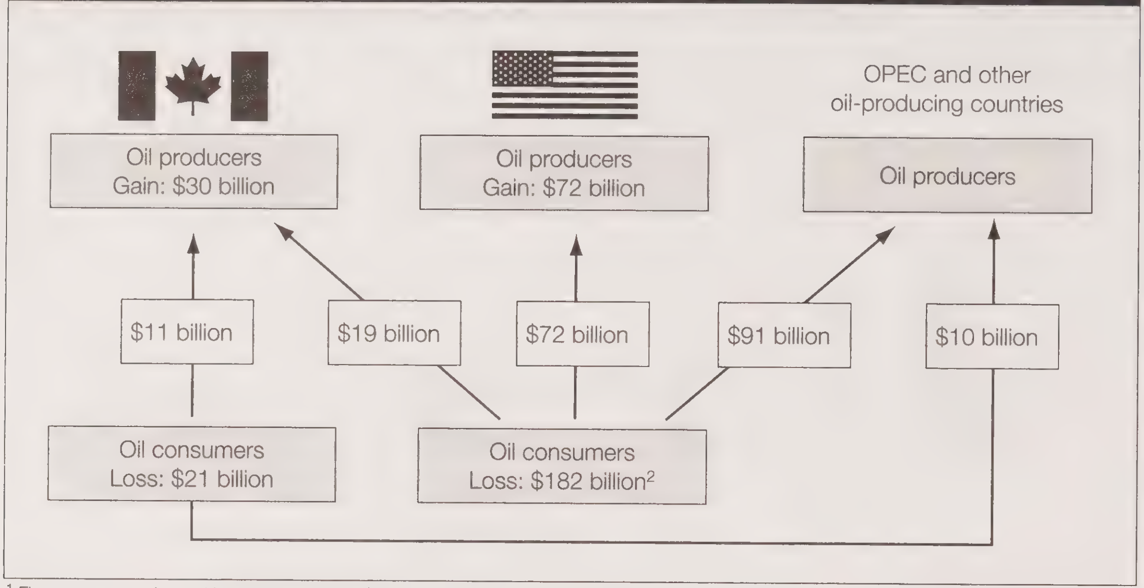
Source: International Energy Agency, *Oil Market Report* (October 2004).

- The recent spike in oil prices has been the result of several factors: strong growth in world demand, notably from China and other non-OECD Asian countries, which are forecast to account for almost 50 per cent of the increase in world demand for oil in 2004; little excess capacity in most OPEC (Organization of the Petroleum Exporting Countries) nations; weather-related damages to oil production facilities in the Gulf of Mexico; uncertainty surrounding Yukos Oil Company's production in Russia; and concerns about possible supply disruptions in Saudi Arabia, Venezuela, Nigeria and Iraq.

- The increase in world demand for oil is projected to slow somewhat in 2005, largely due to weaker demand growth in China and other non-OECD Asian countries. However, these countries will continue to account for a sizeable share of the expected increase in overall world oil demand.

An increase in the price of oil transfers purchasing power from consumers to oil producers, both within and across countries

Effect of a US$20/Barrel Increase in Oil Prices on Purchasing Power of Oil Producers and Consumers in Canada
(Estimated Net Transfers in Canadian Dollars)[1]



[1] Flows are approximated by multiplying a US$20 price increase by the number of barrels consumed, produced and traded per day, annualized and converted into Canadian dollars using the average exchange rate from January to September 2004.

[2] Differences exist between world oil production and world consumption figures due to factors such as stock changes and differences in the definition, measurement or conversion of oil supply and demand data. Cross-checking with the trade flow data suggests that the disparity is largest in the U.S.; thus the U.S. consumption number has been adjusted to account for this statistical discrepancy.

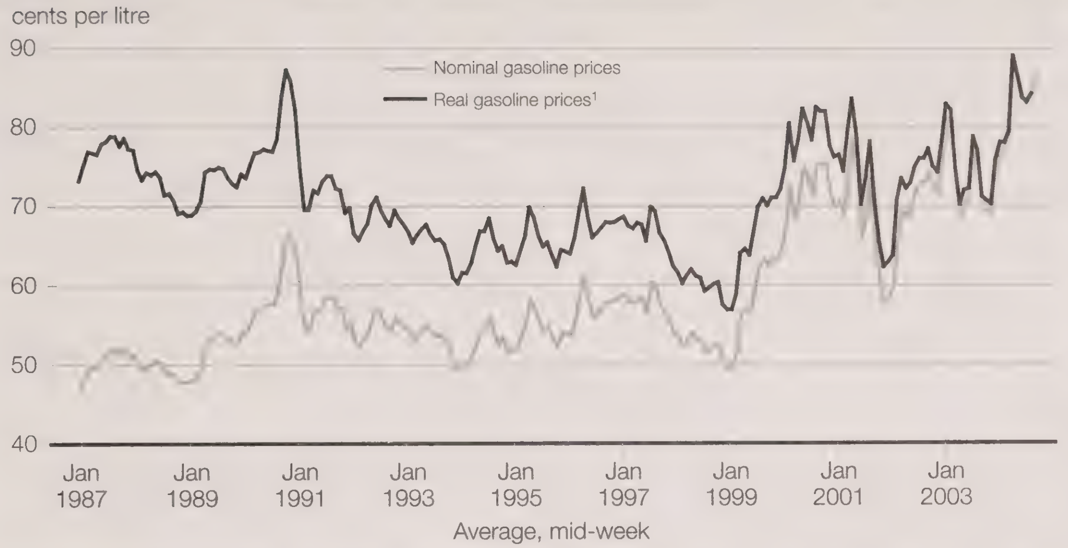
Source: *BP Statistical Review of World Energy* (June 2004).

- Since the March budget, world oil prices have risen by about US$20 a barrel. Based on the number of barrels of oil consumed in Canada per day in 2003 (by businesses and households), a US$20-per-barrel price increase over the course of a year reduces the purchasing power of oil consumers by about $21 billion. On a per capita basis, U.S. oil consumers incur a similar loss.

- However, higher oil prices lead to a gain for oil producers, with transfers occurring both within and across countries. Since Canada sells more oil on the world market than it buys, the US$20 price increase results in a net income flow of approximately $9 billion from the rest of the world to Canada. This stems from an outflow of $10 billion from Canada to other oil-producing countries (Canada imports about half of its oil consumption), which is more than offset by an inflow of $19 billion from oil consumers in the United States.

Rising oil prices raise gasoline and other energy prices, which negatively affects consumers

Gasoline Prices in Canada



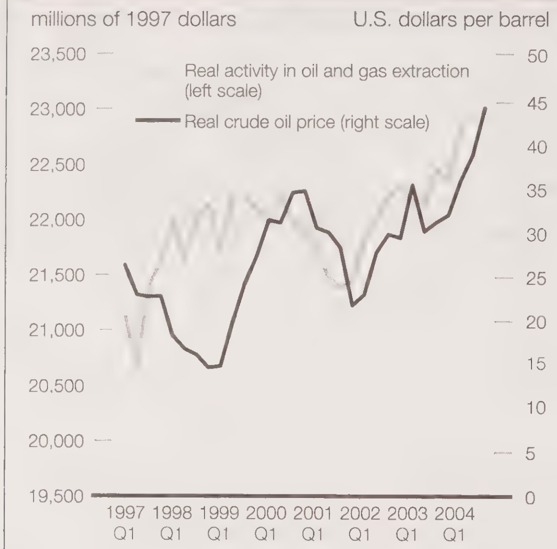
[1] Real gasoline prices are nominal prices deflated by the total CPI (September 2004 = 1.0).
Sources: MJ Ervin & Associates and Statistics Canada.

- Canadian households are affected by higher world oil prices via higher gasoline and heating fuel prices, which usually move in response to changes in the price of crude oil. Indeed, gasoline prices in Canada reached record levels in 2004, although their current levels and recent run-up are not unprecedented in real terms.
- Since gasoline and heating fuel are necessities for most households, in the short term rising prices reduce the income available to purchase other goods and services. This reduces real consumer spending in Canada and dampens exports, as consumers in other countries—particularly the U.S.—demand fewer imports.[4]
- Higher oil prices also lead to higher input costs for firms in the non-energy sector. Since firms are generally unable to pass the higher costs on to consumers immediately, this may lead to lower profits, reduced business investment or production cutbacks for these firms.

[4] For instance, the IMF estimates that every US$10-per-barrel increase in crude oil subtracts 0.4 percentage points from U.S. real GDP growth.

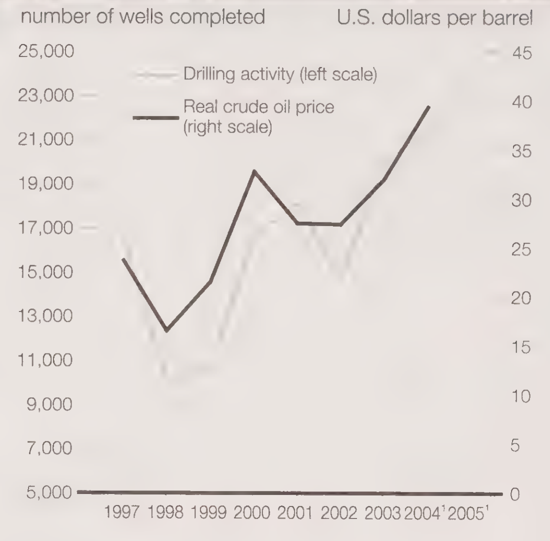
However, rising oil prices also induce oil producers to increase drilling activity and investment in Canada

Oil and Gas Extraction Industry Output in Canada and Oil Prices



Sources: Statistics Canada, Bridge Commodity Research Bureau and Bureau of Economic Analysis.

Drilling Activity in Canada and Oil Prices



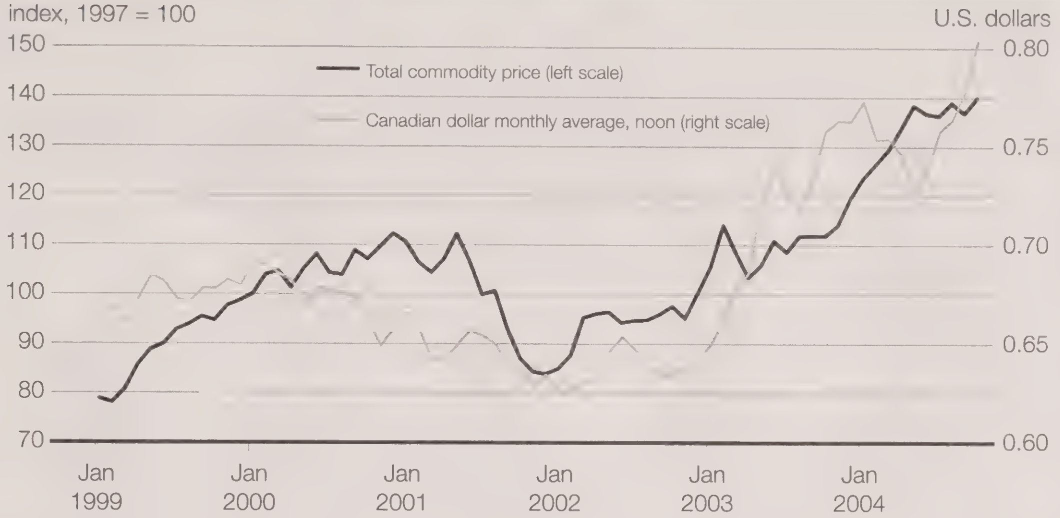
[1] Forecasts for 2004 and 2005. The 2005 forecast is based on an oil price assumption of US$40 per barrel.

Sources: Canadian Association of Oilwell Drilling Contractors, Bridge Commodity Research Bureau and Bureau of Economic Analysis.

- On the positive side, higher oil prices stimulate investment and production in Canada's energy sector, supporting output and employment growth.
- Coinciding with the recent rise in the price of crude oil since the beginning of 2002, output in the oil and gas extraction industry has increased markedly in Canada. Over this period employment in this industry has increased nearly 10 per cent, while employment in support activities for oil and gas extraction (and mining) has increased more than 50 per cent.
- High oil and gas prices also prompt producers to invest more in drilling activity aimed at boosting production. Based on data for the first nine months of the year, the Canadian Association of Oilwell Drilling Contractors expects drilling activity to reach record highs this year and next.

The Canadian dollar has risen significantly, driven in part by stronger commodity prices...

Commodity Prices and the Canadian Dollar



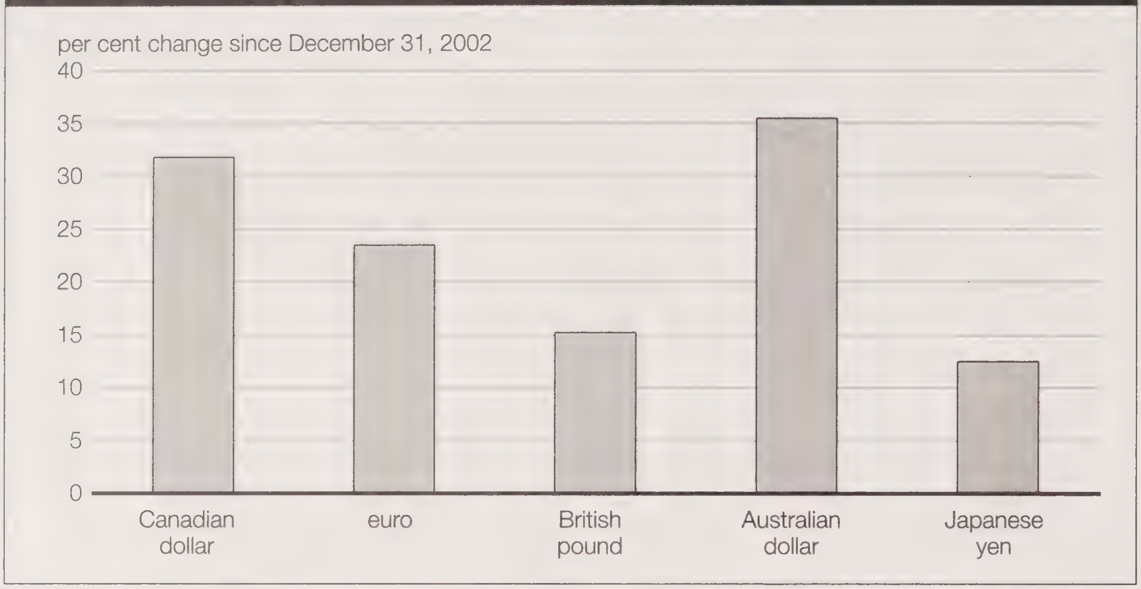
Sources: Department of Finance Commodity Price Index and the Bank of Canada.

- Since the beginning of 2003, the Canadian dollar has appreciated more than 30 per cent against the U.S. dollar reflecting, in part, rising commodity prices. The Canadian dollar often rises against the U.S. dollar when commodity prices are strong, as has been the case recently. In addition, adjustments to global current account imbalances have contributed to the recent appreciation of the Canadian dollar.

- An appreciation of the Canadian dollar driven by rising commodity prices would normally be accompanied by stronger activity in the commodity-producing sector, which would partly offset the negative effects on non-commodity exporters. To the extent that higher commodity prices reflect strong global demand, this would also provide some offset in the non-commodity sectors.

...but also by an ongoing adjustment to global current account imbalances...

The Performance of Major Currencies vs. the U.S. Dollar

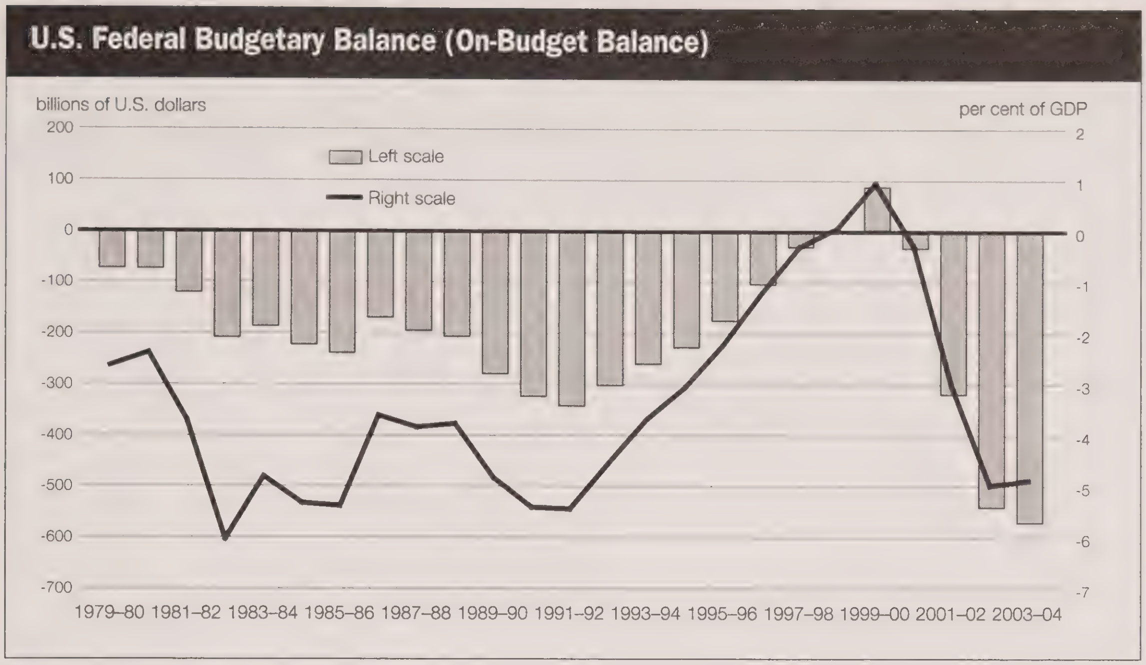


Source: Bank of Canada.

- On the other hand, an appreciation of the Canadian dollar due to ongoing portfolio adjustments to global current account imbalances poses a greater risk to Canadian growth because the appreciation does not reflect an improvement in Canada's underlying growth prospects. Such a portfolio shift appears to have occurred in 2003, when all major currencies including the Canadian dollar appreciated against the U.S. dollar.

- The timing and magnitude of further portfolio-driven adjustments to the Canadian dollar are highly uncertain. Nevertheless, the recent resilience shown by exporters in the face of a stronger Canadian dollar in 2003 suggests that any impact may be short-lived.

...that partly reflects large and growing U.S. fiscal deficits



Source: U.S. Department of the Treasury.

- Over the medium term, the growing U.S. budget deficit remains the principal downside risk. The on-budget deficit reached US$568 billion in 2003–04, its highest level on record, or nearly 5.0 per cent of GDP.
- If not corrected, the U.S. fiscal imbalance could put upward pressure on interest rates, crowd out investment and dampen growth in the United States. On the other hand, a serious effort to reduce the deficit would temporarily lower growth directly. In either case, Canadian and world growth would be negatively affected.
- While the Canadian economy faces a number of downside risks over the near to medium term, a strong monetary, fiscal and structural framework means that the Canadian economy is well positioned to deal with these risks.

Annex 3

Private Sector Five-Year Economic and Fiscal Projections

Highlights

- *The Department of Finance meets each fall with economists from all regions of the country, including the chief economists of the major chartered banks and four private sector economic forecasting organizations. The objective of this exercise, which was initiated in 1999, is to agree on a set of economic assumptions for planning purposes, which the four forecasting organizations then use to develop status quo fiscal projections of the budgetary balance for the current year and each of the next five years.*

- *In this Economic and Fiscal Update the Government is reporting for the first time the individual projections of the budgetary balance provided by the private sector economic forecasting organizations. These projections are prepared on a National Accounts basis. The average of these projections has been translated to a Public Accounts basis by the Department of Finance. Annex 4 provides details on how the projections are translated from a National Accounts basis to a Public Accounts basis.*

- *The private sector economists strongly recommend that the Government continue to set aside amounts in its fiscal plan for the Contingency Reserve and for economic prudence.*

  - *The Contingency Reserve is established to guard against unforeseen developments. If it is not needed, it is used to reduce the federal debt.*
  - *Amounts set aside for economic prudence provide further protection against going back into deficit. If these amounts are not needed, they become available to fund new priorities.*

- *Based on the projections provided by the four forecasting organizations, and after subtracting amounts for the Contingency Reserve and economic prudence, the cost of the September and October 2004 First Ministers' agreements on health, equalization and Territorial Formula Financing, and the cost of other decisions made since the March 2004 budget, the surplus is estimated at $5.9 billion for 2004–05, $0.5 billion for 2005–06, $0.9 billion for 2006–07, $3.2 billion for 2007–08, $7.5 billion for 2008–09 and $11.5 billion for 2009–10.*

- *The key elements of the current approach to budget planning were established following an independent review of the Government's forecasting methods in 1994. Much has changed since then—the elimination of the deficit, the Government's commitment to a balanced budget or better each year, and the shift to full accrual accounting. To ensure that the Government continues to use the most up-to-date forecasting methods, and to benchmark Canadian practices against the best in the world, the Government has launched a new review. Dr. Tim O'Neill, Chief Economist and Executive Vice-President of BMO Financial Group, will lead this review. As well, the International Monetary Fund (IMF) will be conducting a comparative review of the budgeting practices and experiences in Canada with those in other major industrial countries. Recommendations by Dr. O'Neill will be submitted to the House of Commons Standing Committee on Finance for their consideration.*

Approach to budget planning

- The Government's approach to budget planning involves a number of important steps. The first step involves using private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a quarterly basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and leading economic forecasting organizations as well as representatives from different regions of the country.
- The second step involves using the average private sector economic forecasts to develop status quo fiscal projections for the fall Economic and Fiscal Update.
  - Four private sector economic forecasting organizations develop detailed fiscal projections on a National Accounts basis, based on tax and spending policies in place at the time of the last budget.
  - The four organizations are Global Insight, the University of Toronto, the Conference Board of Canada and the Centre for Spatial Economics.
  - These projections are then translated to a Public Accounts basis by the Department of Finance and presented in the fall Economic and Fiscal Update. For the current fiscal year, year-to-date fiscal results are also used to estimate the potential budgetary outcome.
  - The impact of policy decisions since the last budget is then subtracted from these fiscal projections.
- The third step adjusts the resulting fiscal projections for prudence to derive the fiscal surpluses for budget-planning purposes.
  - An annual Contingency Reserve is set aside to guard against unforeseen circumstances. If not needed, it is applied to reduce the federal debt (accumulated deficit). An additional amount for economic prudence is included to provide further protection against falling back into deficit. If this amount is not needed, it becomes available to fund new priorities.
  - The Contingency Reserve is normally set at $3 billion per year, while the economic prudence is generally set at $1 billion in the first year of the five-year planning horizon, rising to $4 billion by year five.

- This prudent approach to budget planning has allowed the federal government to record seven consecutive budgetary surpluses. In 2002 and 2003 Canada was the only country among the Group of Seven (G-7) countries to record a budgetary surplus on a total government basis. The Organisation for Economic Co-operation and Development projects that Canada will be the only G-7 country in surplus this year and next.

- Sound fiscal management means more than prudent planning, avoiding deficits and reducing debt. It also means managing tax dollars responsibly and delivering cost-effective and efficient government services. With this in mind, the Government launched the Expenditure Review Committee (ERC) in December 2003, with a mandate to conduct a fundamental review of all federal programs and expenditures. In August of this year the Prime Minister assigned a dual mandate to the ERC. The immediate task is to conduct a thorough review of government spending to reallocate a cumulative $12 billion from 2005–06 to 2009–10 from lower-priority areas and areas of inefficient spending to higher-priority areas. These savings are not built into the status quo projections. To achieve this the ERC is focusing on both improving government operations and assessing the relevance and effectiveness of current government programs. The second, and equally important, part of the ERC's mandate is to develop a permanent mechanism to review spending on an ongoing basis as part of the yearly budget cycle. This will ensure that the review and reallocation processes are an embedded part of how the federal government does business.

Independent review of economic and fiscal forecasts

- Many of the key elements of the current approach to budget planning were put in place on the recommendation of an independent review of the Department of Finance's approach to economic and fiscal forecasting concluded in 1994.

- Much has changed since then—the elimination of the deficit, the Government's commitment to a balanced budget or better each year, and the shift to full accrual accounting. To ensure that the Government continues to use the most up-to-date economic and fiscal forecasting methods, and to benchmark Canadian practices against the best in the world, the Government of Canada has launched a new review. Dr. Tim O'Neill, Chief Economist and Executive Vice-President of BMO Financial Group, will lead the review. Dr. O'Neill's review will identify and assess the source of differences between the budget and fall update fiscal projections and the outcome. It will also include an evaluation of the changes that have been made to the forecasting process over the last decade.

- As part of this forecasting review, the IMF will be conducting a comparative analysis of the budgeting practices and experiences in Canada and other major industrial countries. The IMF will examine how Canada's fiscal environment compares to that of other countries, including the structure of revenues and spending as well as the fiscal rules and targets. It will compare Canada's forecasting process to that of other nations and provide statistical analysis of the quality of Canada's forecasts as well as the factors that might affect that quality. The IMF will report its findings in the context of its annual review of Canada's economic policy. Its report will be shared with Dr. O'Neill to inform his review.

- Once this work is completed, Dr. O'Neill's report will offer specific recommendations with respect to:
  - Improving the accuracy of the economic projections.
  - Improving the preparation and accuracy of the fiscal projections.
  - Addressing ways of dealing with the uncertainties in economic and fiscal forecasting.

- The review is expected to be concluded in early 2005. The recommendations will be referred to the House of Commons Standing Committee on Finance, which has also been asked to make recommendations relating to the provision of independent fiscal forecasting advice for parliamentarians, including the consideration of the recommendations of the external expert.

Economic assumptions underlying the average private sector status quo fiscal projections

Table 3.1
Average of Private Sector Economic Forecasts: September 2004 Survey

	2004	2005	2006	2007–2009
		(per cent)		
Real GDP growth	3.0	3.2	3.1	2.9
GDP inflation	3.1	2.1	1.8	1.7
Nominal GDP growth	6.2	5.3	5.0	4.7
3-month Treasury bill rate	2.1	3.2	4.4	4.7
10-year Government of Canada bond rate	4.7	5.0	5.7	6.0

Notes: Based on a survey conducted by the Department of Finance in mid-September.
The number of respondents declines from 18 in 2004 to 8 in 2009.
The survey results have been adjusted slightly after further consultations with economists to reflect developments since September.

- The average private sector forecast of real gross domestic product (GDP) growth is 3.0 per cent in 2004, 3.2 per cent in 2005 and 3.1 per cent in 2006. The average growth forecast over the 2007 to 2009 period is 2.9 per cent.
  - GDP inflation is expected to be 3.1 per cent in 2004, decline to 2.1 per cent in 2005, and average around 1.7 per cent annually through 2009.
  - As a result, nominal GDP growth is expected to average 6.2 per cent in 2004, up significantly from the growth of 4.1 per cent forecast in the March 2004 budget. However, it is forecast to slow to 5.3 per cent in 2005, up slightly from the March 2004 budget forecast, and 5.0 per cent in 2006. Over the 2007 to 2009 period, nominal GDP growth is forecast to average 4.7 per cent. As a result of the higher growth expected for 2004, the level of nominal income—the broadest measure of the Government's tax base—is forecast to be higher throughout the five-year period than forecast in the March 2004 budget.
- Short-term interest rates are expected to average 2.1 per cent in 2004 before rising to 3.2 per cent in 2005 and 4.4 per cent in 2006. Over the 2007 to 2009 period, short-term interest rates are expected to average 4.7 per cent. Private sector forecasters project a gradual rise in longer-term interest rates between 2004 and 2009 from 4.7 per cent in 2004, to 5.7 per cent by 2006 and averaging 6.0 per cent over the 2007 to 2009 period.

Planning assumptions used to develop the five-year status quo fiscal projections

- The four private sector forecasting organizations derived projections of the major components of the federal budgetary balance on a National Accounts basis, using the economic forecasts outlined in Table 3.1. These projections were converted to a Public Accounts basis, on a full accrual basis of accounting, by the Department of Finance. For details, see Annex 4. The projections are based on the following assumptions.
  - The projections include the impact of the policy initiatives announced in previous budgets. However, they do not include the impact of the agreements reached at the recent First Ministers' Meetings on health, equalization and Territorial Formula Financing, as well as other policy decisions taken since the 2004 budget.
  - For direct program spending, the private sector projections are consistent with expenses reported in the 2004 budget for 2004–05 and 2005–06. Starting in 2006–07, the projections assume underlying growth of population plus inflation, except in circumstances where there are economic or policy factors (reflecting past budget decisions) that drive spending.
  - In light of the detailed information required to prepare projections of direct program spending and public debt charges, the private sector organizations agreed to use National Accounts projections provided by the Department of Finance. Major transfers to other levels of government were set to be consistent with the September 16 meeting of First Ministers.
  - In Budget 2003 the Government announced that it would consult on a new permanent employment insurance (EI) rate-setting regime for 2005 and beyond, based on the following rate-setting principles: premium rates should be set transparently; premium rates should be set based on independent expert advice; expected premium revenues should correspond to expected program costs; premium rate setting should mitigate the impact of the business cycle; and premium rates should be relatively stable over time. Consistent with these principles, the four forecasting organizations were asked to set projected premiums equal to their projected program costs on an annual basis for 2005 to 2009.

Status quo fiscal projections on a National Accounts basis

Table 3.2
Private Sector Surplus Projections

	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
			(billions of dollars)			
Global Insight	10.2	11.3	13.7	17.3	22.2	27.0
University of Toronto	8.4	10.1	12.7	15.7	19.8	23.7
Conference Board of Canada	6.9	8.8	11.2	15.0	20.0	24.8
Centre for Spatial Economics	7.8	7.7	12.3	16.1	20.5	24.6
Average	8.3	9.5	12.5	16.0	20.7	25.0
Forecast range	3.3	3.6	2.6	2.3	2.4	3.3

- The private sector organizations provided projections of the Government's budgetary balance before subtracting amounts for economic prudence and the Contingency Reserve. The projections do not include the impact of policy decisions announced since the 2004 budget. In particular, these projections do not reflect the proposed cost of commitments made at the two recent First Ministers' Meetings on health, equalization and Territorial Formula Financing.

- On average, the four forecasting organizations project a surplus of $8.3 billion in 2004–05, $9.5 billion in 2005–06, $12.5 billion in 2006–07, rising thereafter to reach $25.0 billion in 2009–10.

- The differences in the projections primarily reflect differing assumptions about the responsiveness of tax revenues to growth in the various income tax bases.
  - Global Insight projects the highest surpluses on average, primarily because it expects a higher rate of growth of personal income tax revenues in 2004–05 relative to the other three forecasting organizations.
  - In 2004–05 and 2005–06, the Centre for Spatial Economics projects relatively low surpluses, largely because it expects weaker corporate income tax revenues.
  - The Conference Board of Canada and the University of Toronto project surpluses that are largely in line with average projections, although the Conference Board projects a relatively low surplus in 2004–05.

- The range in the projections peaks at $3.6 billion in 2005–06. In other years the difference in projections ranges between $2.3 billion and $3.3 billion. These differences are relatively small in relation to combined federal revenues and expenses of $360 billion. For example, a 1-per-cent change in revenues and expenses translates into a difference of $3.6 billion in the budgetary balance.

Status quo fiscal projections on a Public Accounts basis

Table 3.3
Average Private Sector Surplus Projection—Status Quo (Not Including New Policy Initiatives Since the 2004 Budget)

	Actual	Projection					
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(billions of dollars)						
National Accounts basis							
Average of private sector surplus projections	3.7	8.3	9.5	12.5	16.0	20.7	25.0
Adjustments for 2004–05							
Personal income tax		3.4	3.6	3.8	4.0	4.3	4.6
Corporate income tax		-2.8	-2.8	-2.9	-2.9	-2.9	-2.9
Goods and services tax		-0.5	-0.5	-0.5	-0.5	-0.5	-0.6
Total		0.1	0.3	0.4	0.6	0.9	1.1
Adjustments—National Accounts to Public Accounts							
Provisions related to transfers to other levels of government	4.2	2.1					
Asset sales and revaluations	0.3	2.2	0.1	0.1	-0.1	-0.1	-0.2
Pension amortization	-2.0	-2.4	-2.8	-3.2	-3.9	-4.1	-4.1
Other	2.9	2.5	2.4	1.8	2.5	3.0	3.5
Total	5.4	4.4	-0.3	-1.3	-1.5	-1.2	-0.8
Public Accounts basis	9.1	12.8	9.5	11.6	15.2	20.3	25.3

- A detailed reconciliation of the National Accounts and Public Accounts projections by component is provided in Annex 4. Some of the key adjustments of the translation to a Public Accounts basis are provided in Table 3.3.
  - The first step in converting projections from a National Accounts basis to a Public Accounts basis is to incorporate the most recent fiscal data available.
  - Estimates of government revenues and expenses on a National Accounts basis normally lag Public Accounts estimates by several months. For example, the second-quarter National Accounts data reflect fiscal data through June 2004 and do not incorporate the final 2003–04 results.
- The Department of Finance made three adjustments to the private sector projections on the basis of the final results for 2003–04 and the tax collections experience through September 2004.
  - First, fiscal data through September 2004 suggest that personal income tax revenues should increase by about 5 per cent in 2004–05. The private sector projections were increased by $3.4 billion in 2004–05 to achieve this growth. In future years this adjustment is assumed to grow in line with National Accounts personal income tax revenues. As a result, the growth in personal income tax revenues in future years is consistent with the economic growth forecast by the private sector forecasters.

- Second, corporate income tax receipts in 2003–04 were affected by a one-time gain in corporate income tax receipts in the financial services industry. The one-time gain was related to downward revaluations of U.S.-dollar-denominated liabilities as a result of the increase in the value of the Canadian dollar. To reflect the one-time nature of these gains, the private sector projections were adjusted down by $2.8 billion in 2004–05, with the adjustment growing in line with National Accounts corporate income tax revenues over the planning period.
- Third, the average private sector projection of goods and services tax (GST) revenues was adjusted downward to reflect expected GST revenues over the remainder of 2004–05. Over the planning period, the adjustment grows in line with National Accounts GST revenues.

■ The remaining adjustments reflect differences in the accounting treatment of revenues and expenses between the two accounting systems.

- There are differences related to when liabilities are recognized under the two accounting systems. For example, payments made to provinces through Canada Health and Social Transfer supplements in the 2004 budget are reported in 2004–05 in the National Accounts, while they were recorded in 2003–04 on a Public Accounts basis.
- The net revenue gain from the sale of the Government's remaining shares in Petro-Canada is not accounted for in the National Accounts. These are added to the Public Accounts estimate of the surplus. Similarly, the impact of foreign exchange revaluations of financial assets is not part of the budget balance in the National Accounts but is captured in the Public Accounts.
- The National Accounts projection assumes high and constant capital transfers from persons to the Government related to the amortization of surpluses in employee pension accounts. In the Public Accounts this amortization is much lower and continues to fall over the projection period.
- Finally, there are a large number of other adjustments, mostly reflecting the fact that the National Accounts do not yet incorporate the final 2003–04 Public Accounts information.

■ The average of the four forecasting organizations' fiscal projections, converted to a Public Accounts basis, but prior to adjusting for new policy decisions since the 2004 budget, or any allocation for the Contingency Reserve and economic prudence, results in a fiscal surplus of $12.8 billion in 2004–05, $9.5 billion in 2005–06, $11.6 billion in 2006–07, $15.2 billion in 2007–08, $20.3 billion in 2008–09 and $25.3 billion in 2009–10.

■ To derive the fiscal balance for planning purposes, decisions made since the 2004 budget must be deducted from these amounts as well as amounts for the Contingency Reserve and economic prudence.

Fiscal impact of policy initiatives since the 2004 budget

Table 3.4
Initiatives Announced Since the March 2004 Budget

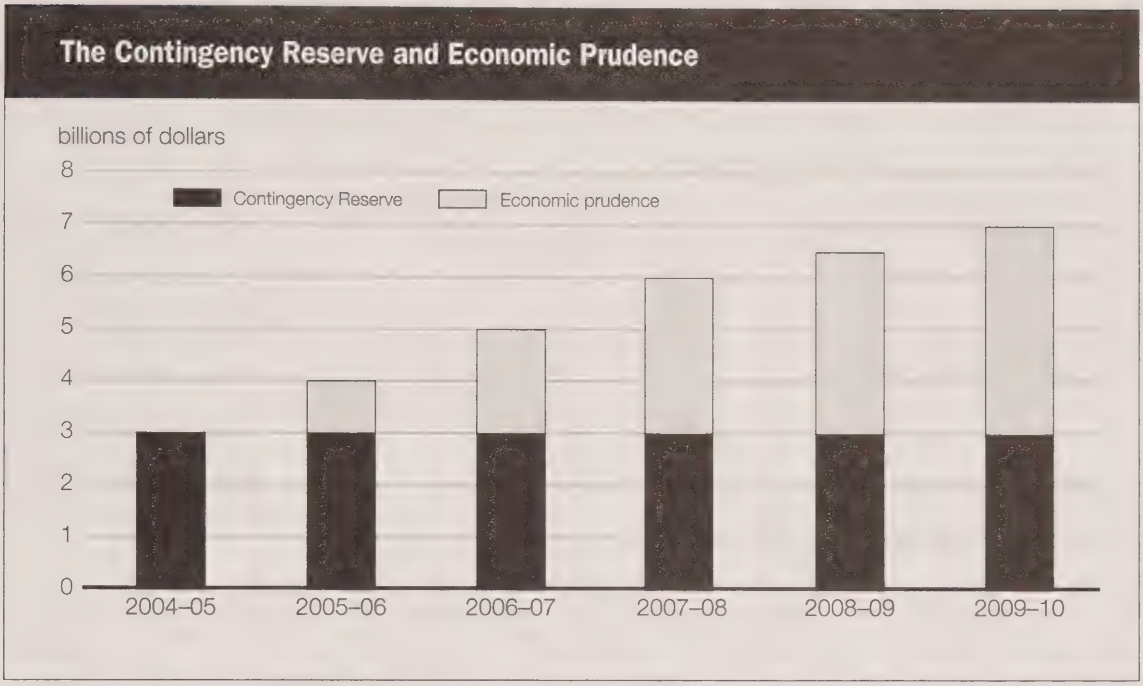
	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10	Total
			(millions of dollars)				
10-Year Plan to Strengthen Health Care							
Federal transfers							
Close short-term Romanow gap	1,000	2,000					3,000
Addition to Canada Health Transfer base (home care/catastrophic drug coverage)		500					500
Escalator (6% growth starting in 2006–07)			2,240	2,098	2,429	2,787	9,555
Wait Times Reduction Fund	625	625	1,200	1,200	600	250	4,500
Medical equipment	500						500
Total	2,125	3,125	3,440	3,298	3,029	3,037	18,055
Direct federal initiatives:							
Aboriginal health		65	110	175	175	175	700
Territorial Health Access Fund		30	30	30	30	30	150
Total		95	140	205	205	205	850
Equalization/Territorial Formula Financing framework[1]							
Equalization	1,321	1,390	1,772	2,166	2,575	2,998	12,222
Territorial Formula Financing	133	200	270	342	417	495	1,858
Total	1,454	1,590	2,042	2,508	2,992	3,493	14,080
Total First Ministers' Meetings commitments	3,579	4,810	5,622	6,011	6,226	6,735	32,985
Other initiatives							
Additional bovine spongiform encephalopathy initiatives	311	187	24	12	12		544
Other	40	35	73	61	42	42	294
Total	351	222	97	73	54	42	839
Total spending decisions since Budget 2004	3,930	5,032	5,719	6,084	6,280	6,777	33,824

Note: Numbers may not add due to rounding.

[1] Amounts for the Atlantic and Nova Scotia offshore agreements are not included as they are currently under discussion.

- The Government is committed to proposed new funding of nearly $75 billion over 10 years to the provinces and territories in support of health, equalization and Territorial Formula Financing (subject to the passage of authorizing legislation).
  - At the First Ministers' Meeting in September 2004, the Government, all the provincial premiers and all territorial leaders signed the 10-Year Plan to Strengthen Health Care, which will provide $41.3 billion over 10 years to the provinces and territories. Over the planning period, this agreement will increase federal funding for health care by $18.9 billion, including $18.1 billion in the form of transfers to provinces and territories.
  - In October 2004, the Government committed to increasing equalization and Territorial Formula Financing by more than $33 billion over the next 10 years relative to Budget 2004 levels for 2004–05. Over the planning period, this agreement will increase transfers to provinces and territories by $14.1 billion.
- Total commitments arising from the First Ministers' Meetings amount to $3.6 billion in 2004–05, rising to $6.7 billion in 2009–10, for a cumulative total of $33.0 billion over the six-year period.
- Since the March 2004 budget, the Government has announced additional assistance to help the Canadian cattle and beef industry to offset the impact of border closures following the discovery of a single cow with bovine spongiform encephalopathy, as well as other initiatives such as increased funding for the Canadian Strategy on HIV/AIDS and support for the auto sector.

Allocation for prudence



- Private sector forecasters strongly advise that the Government maintain the $3-billion annual Contingency Reserve and set aside additional amounts for economic prudence. Despite the recent strengthening of the economy, high oil prices, the rise of the Canadian dollar and the U.S. budgetary deficit pose risks to the economic outlook, as described in Annex 2.

- The Contingency Reserve is set at $3 billion annually. Economic prudence is set at $1 billion in the first year of the five-year planning horizon, rising to $4 billion by year five.

- The Contingency Reserve and economic prudence are used to absorb the fiscal impact of short- and longer-term economic and other shocks. They provide a buffer to protect the annual balanced budget target, to avoid having to undo previous budget initiatives, and to avoid going back into deficit.

- If the Contingency Reserve is not required, it is applied to reduce the federal debt (accumulated deficit). If the economic prudence is not required, it is made available for budget planning.

Average of private sector projections of the fiscal surplus

Table 3.5
Surpluses for Purposes of Fiscal Planning

	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
			(billions of dollars)			
Average of private sector surplus projection: status quo	12.8	9.5	11.6	15.2	20.3	25.3
Initiatives announced since the March 2004 budget	3.9	5.0	5.7	6.1	6.3	6.8
Allocation for prudence						
Contingency Reserve	3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence		1.0	2.0	3.0	3.5	4.0
Total	3.0	4.0	5.0	6.0	6.5	7.0
Surplus for planning purposes	5.9	0.5	0.9	3.2	7.5	11.5

Note: Numbers may not add due to rounding.

- Table 3.5 adjusts the status quo projections for initiatives announced since the 2004 budget and for the Contingency Reserve and economic prudence.
  - As a result, the surplus for planning purposes is $5.9 billion in 2004–05, $0.5 billion in 2005–06, $0.9 billion in 2006–07, $3.2 billion in 2007–08, $7.5 billion in 2008–09 and $11.5 billion in 2009–10. Over the six-year period, the cumulative surplus for planning purposes totals $29.5 billion.
- The $5.9-billion surplus in 2004–05 reflects a number of factors.
  - The net proceeds from the sale of the Government's remaining shares in Petro-Canada increase revenues by $2.6 billion.
  - Public debt charges are expected to decline by $1.1 billion, reflecting lower interest rates in 2004.
  - The release of $1 billion in economic prudence set aside in the 2004 budget for the current year, as is normal practice in the fall Economic and Fiscal Update.

Average of private sector fiscal projections

Table 3.6
Summary Statement of Transactions

	Actual	Projection					
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(billions of dollars)						
Budgetary transactions							
Budgetary revenues	186.2	194.0	199.4	209.7	220.3	231.2	242.3
Total expenses							
Program expenses	-141.4	-150.5	-159.1	-166.8	-173.9	-180.2	-186.7
Public debt charges	-35.8	-34.7	-35.9	-37.0	-37.3	-37.0	-37.1
Total expenses	-177.1	-185.2	-194.9	-203.8	-211.2	-217.2	-223.8
Budgetary surplus	9.1	8.9	4.5	5.9	9.2	14.0	18.5
Prudence							
Contingency Reserve		3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence			1.0	2.0	3.0	3.5	4.0
Total		3.0	4.0	5.0	6.0	6.5	7.0
Planning surplus	9.1	5.9	0.5	0.9	3.2	7.5	11.5
Federal debt							
Assuming balanced budget	501.5	501.5	501.5	501.5	501.5	501.5	501.5
Assuming Contingency Reserve applied to debt reduction	501.5	498.5	495.5	492.5	489.5	486.5	483.5
Per cent of GDP							
Budgetary revenues	15.3	15.0	14.6	14.7	14.7	14.7	14.8
Program expenses	11.6	11.6	11.7	11.7	11.6	11.5	11.4
Public debt charges	2.9	2.7	2.6	2.6	2.5	2.4	2.3
Total expenses	14.5	14.3	14.3	14.3	14.1	13.9	13.6
Planning surplus	0.7	0.5	0.0	0.1	0.2	0.5	0.7
Federal debt							
Assuming balanced budget	41.1	38.8	36.8	35.1	33.5	32.0	30.6
Assuming Contingency Reserve applied to debt reduction	41.1	38.6	36.4	34.5	32.7	31.0	29.5

Note: Numbers may not add due to rounding.

- Table 3.6 sets out the details of the fiscal projections to 2009–10.
- The profile of the budget-planning surplus in 2004–05 and 2005–06 reflects the combination of policy decisions related to tax reductions and spending increases, as well as a one-time gain in 2004–05 from the sale of the Government's remaining shares in Petro-Canada.
- Budgetary revenues are expected to increase by $7.9 billion in 2004–05, and $5.4 billion in 2005–06. Thereafter revenues increase by about $11 billion per year. The increase in revenues reflects strong growth in nominal income. The revenue gains in 2004–05 and 2005–06 are tempered by the impact of previously announced tax reductions, the one-time gain from the sale of the Government's shares in Petro-Canada and a decline in EI premium revenues in 2005–06.
- Reflecting primarily the impacts of the February 2003 First Ministers' Accord on Health Care Renewal and the September and October 2004 First Ministers' agreements on health, equalization and Territorial Formula Financing, program expenses are expected to increase by $9.1 billion in 2004–05, $8.6 billion in 2005–06, $7.8 billion in 2006–07 and by about $6.5 billion per year thereafter.
- Public debt charges are expected to decline by $1.1 billion in 2004–05, reflecting the impact of lower short-term interest rates. Thereafter the increase in short-term interest rates and the refinancing of maturing long-term bonds at higher interest rates push up public debt charges by $1.2 billion in 2005–06 and a further $1.1 billion in 2006–07.
- The revenue-to-GDP ratio was 15.3 per cent in 2003–04, down significantly from 17.0 per cent in 2000–01, primarily reflecting the impact of tax reduction measures. It is expected to decline to 15.0 per cent in 2004–05, reflecting the incremental impact of tax measures announced in and since the 2000 budget. The revenue ratio declines further in 2005–06, reflecting the one-time gain in 2004–05 from the sale of the Government's Petro-Canada shares.
- The program expenses-to-GDP ratio was 11.6 per cent in 2003–04, well below the level of 15.7 per cent in 1993–94. It is projected to remain stable until 2006–07 before falling slightly in the last three years.
- Public debt charges as a per cent of GDP were 2.9 per cent in 2003–04, a significant drop from the peak of 6.6 per cent in 1990–91. Public debt charges are expected to fall to 2.7 per cent of GDP in 2004–05 and to continue to decline throughout the planning horizon. As a percentage of revenues, public debt charges are projected to decline to 15.3 per cent in 2009–10 from 19.2 per cent in 2003–04.
- The federal debt-to-GDP ratio (accumulated deficit) stood at 41.1 per cent in 2003–04, down dramatically from its peak of 68.4 per cent in 1995–96. Assuming no incremental debt reduction, it would fall to about 30.6 per cent by 2009–10.

Average private sector projections of budgetary revenues

Table 3.7
Average Private Sector Projections of Budgetary Revenues

	Actual	Projection					
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)						
Tax revenues							
Income tax							
Personal income tax	84,895	89,257	95,056	101,597	108,665	116,273	124,147
Corporate income tax	27,431	28,025	28,426	29,265	29,403	29,270	29,397
Other income tax	3,142	3,525	3,543	3,641	3,732	3,801	3,847
Total income tax	115,468	120,808	127,026	134,503	141,800	149,344	157,390
Excise taxes/duties							
Goods and services tax	28,286	29,498	30,773	32,237	33,991	35,747	37,324
Customs import duties	2,887	2,785	2,882	3,048	3,180	3,373	3,450
Other excise taxes/duties	10,192	10,490	10,631	10,767	10,957	11,179	11,400
Total excise taxes/duties	41,365	42,773	44,285	46,052	48,128	50,299	52,174
Total tax revenues	156,833	163,581	171,311	180,555	189,928	199,643	209,565
Employment insurance premium revenues	17,546	17,190	16,827	17,174	17,675	18,420	19,098
Other revenues	11,829	13,275	11,289	11,959	12,721	13,140	13,642
Total budgetary revenues	186,208	194,045	199,426	209,688	220,325	231,203	242,305
Per cent of GDP							
Personal income tax	7.0	6.9	7.0	7.1	7.3	7.4	7.6
Corporate income tax	2.3	2.2	2.1	2.0	2.0	1.9	1.8
Goods and services tax	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Other excise	1.1	1.0	1.0	1.0	0.9	0.9	0.9
Tax revenues	12.9	12.7	12.6	12.6	12.7	12.7	12.8
Employment insurance premium revenues	1.4	1.3	1.2	1.2	1.2	1.2	1.2
Other revenues	1.0	1.0	0.8	0.8	0.9	0.8	0.8
Total	15.3	15.0	14.6	14.7	14.7	14.7	14.8

Note: Numbers may not add due to rounding.

- Budgetary revenues are projected to increase by 4.2 per cent in 2004–05. This reflects the impact of strong growth in personal income, somewhat offset by the impact of the implementation of the final phase of the $100-billion Five-Year Tax Reduction Plan on personal income tax revenues (via the increase in the income threshold to which the statutory rates apply) and on corporate income tax revenues (via the 2-point reduction in the corporate income tax rate from 23 to 21 per cent).

- In 2005–06 budgetary revenues are projected to grow by only 2.8 per cent, primarily due to decreases in EI premium revenues and other revenues, the latter reflecting the one-time gain in 2004–05 from the sale of the Government's Petro-Canada shares. Beyond 2005–06 the average of the private sector projections for revenue growth is broadly in line with the growth in nominal GDP.

- Personal income tax—the largest component of budgetary revenues—falls slightly as a percentage of GDP in 2004–05, reflecting the final impact of the $100-billion Five-Year Tax Reduction Plan. Thereafter it increases as a percentage of GDP, reflecting the progressivity of the income tax system.

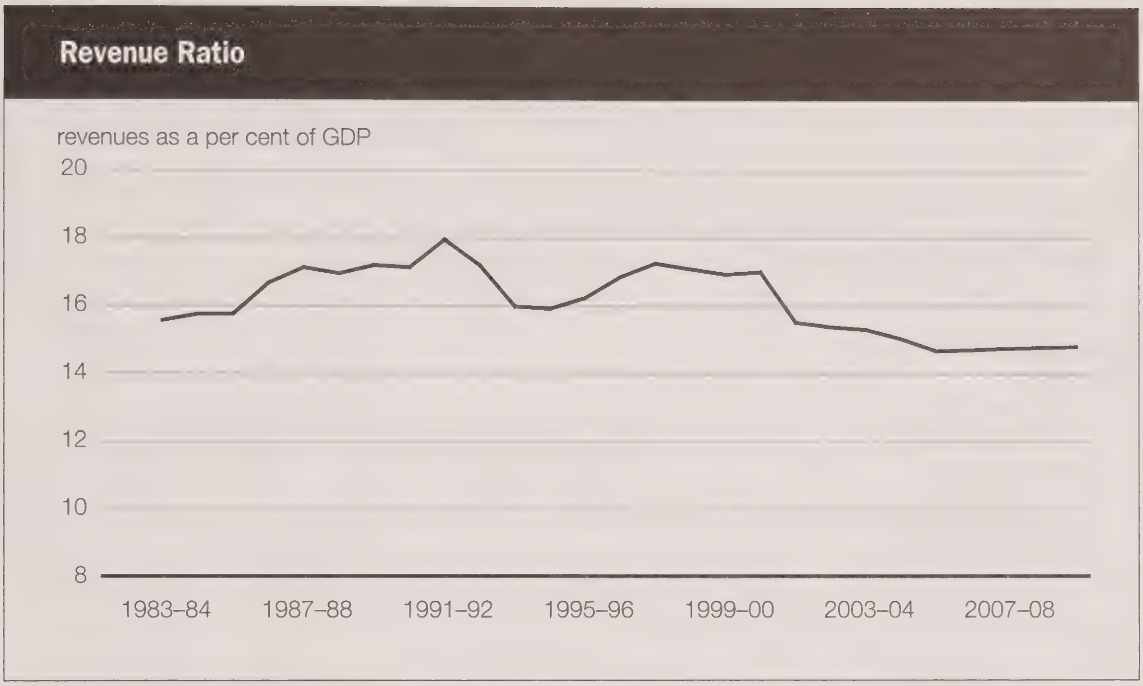
- In 2004–05 corporate income tax revenues are expected to increase 2.2 per cent following a 23.4-per-cent, or $5.2-billion, increase in 2003–04. Much of the increase in 2003–04 resulted from a one-time foreign exchange gain by the chartered banks, which is not expected to carry forward over the planning period. Beyond 2004–05 corporate income tax revenues are expected to grow broadly in line with corporate profits.

- Excise taxes and duties are expected to increase by 3.4 per cent in 2004–05, after remaining relatively flat in 2003–04. The projection for GST revenues includes the impact of providing a 100-per-cent rebate to municipalities for GST paid on their inputs. Excise taxes and duties as a percentage of GDP remain relatively stable over the outlook.

- Over the projection period, EI premium revenues are assumed to match EI program costs. The decline in EI premium revenues in 2004-05 and 2005–06 reflects the private sector projected decline in EI benefits.

- Other revenues include revenues from enterprise Crown corporations, foreign exchange revenues, return on investments and sales of goods and services. These revenue sources are volatile, owing partly to the impact of revaluations of exchange rate movements on foreign-denominated interest-bearing assets and to net gains/losses from enterprise Crown corporations. In 2004–05 other revenues are projected to increase 12.2 per cent, or $1.4 billion, which largely reflects a one-time gain from the sale of the Government's Petro-Canada shares, offset somewhat by losses realized on revaluations of U.S.-dollar-denominated assets.

Revenue ratio



Sources: Department of Finance and Statistics Canada.

- A more revealing picture of movements in tax revenue can be obtained by examining the "revenue ratio"—total federal revenues in relation to the total income in the economy (or GDP).
- This ratio primarily reflects the impact of policy decisions and economic developments. The ratio declines during economic downturns and tends to increase during recoveries, reflecting the progressive nature of the tax system and the cyclical nature of corporate profits.
- The decrease in the ratio in 2001–02 was largely attributable to the implementation of the $100-billion Five-Year Tax Reduction Plan. Thereafter the decline in the ratio reflects both the incremental impact of the Five-Year Tax Reduction Plan and the tax reductions announced in the February 2003 budget.
- The revenue ratio is projected to decline from 17.0 per cent in 2000–01 to 14.6 per cent in 2005–06, remaining in the 14.7 to 14.8 per cent range over rest of the planning period.
- As mentioned above, the decline in the revenue ratio in 2004–05 and 2005–06 reflects the implementation of the final phase of the $100-billion Five-Year Tax Reduction Plan in January 2004, lower EI premium revenues in 2005–06, and the one-time boost to revenues in 2004–05 from the sale of the Government's shares in Petro-Canada.

Average private sector projections of program expenses

Table 3.8
Average Private Sector Projections of Program Expenses

	Actual	Projection					
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)						
Major transfers to persons							
Elderly benefits	26,902	27,802	28,893	30,011	31,222	32,596	34,046
Employment insurance benefits	15,058	15,012	15,201	15,689	16,182	16,988	17,650
Total	41,960	42,814	44,094	45,700	47,404	49,584	51,696
Major transfers to other levels of government							
Federal transfers in support of health and other social programs	22,741	24,175	27,850	29,840	31,348	32,279	33,587
Fiscal arrangements	9,351	12,206	12,321	12,737	13,163	13,606	14,054
Alternative Payments for Standing Programs	-2,700	-2,668	-2,765	-2,928	-3,110	-3,295	-3,536
Total	29,392	33,713	37,406	39,649	41,401	42,590	44,105
Other program expenses	70,003	73,961	77,552	81,485	85,077	88,017	90,920
Total program expenses	141,355	150,488	159,052	166,834	173,882	180,191	186,721
Per cent of GDP							
Major transfers to persons							
Elderly benefits	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Employment insurance benefits	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Total	3.4	3.3	3.2	3.2	3.2	3.2	3.2
Major transfers to other levels of government							
Federal transfers in support of health and other social programs	1.9	1.9	2.0	2.1	2.1	2.1	2.1
Fiscal arrangements	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Alternative Payments for Standing Programs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Total	2.4	2.6	2.7	2.8	2.8	2.7	2.7
Direct program expenses	5.7	5.7	5.7	5.7	5.7	5.6	5.5
Total program expenses	11.6	11.6	11.7	11.7	11.6	11.5	11.4

Note: Numbers may not add due to rounding.

- Table 3.8 provides projections of program expenses that include the cost of policy decisions announced since the 2004 budget, as set out in Table 3.4.

- Program expenses are divided into three major components: major transfers to persons, major transfers to other levels of government and other program expenses—the latter include subsidies and other transfers, expenses of Crown corporations, and defence and all other departmental operating expenses.

- Program expenses are expected to increase by $9.1 billion, or 6.5 per cent, in 2004–05, with about one-half of this increase due to higher transfers to other levels of government, reflecting the impact of the recent First Ministers' agreements on health, equalization and Territorial Formula Financing as well as the February 2003 First Ministers' Accord on Health Care Renewal. Thereafter, based on the average of the projections provided by the four forecasting organizations, total program expenses are estimated to increase broadly in line with the increase in nominal GDP before falling off in the last three years of the planning period.

- Major transfers to persons, consisting of elderly and EI benefits, are expected to increase by $0.9 billion in 2004–05. The growth in elderly benefits of $0.9 billion, or 3.3 per cent, is largely determined by the growth in the elderly population and average benefits, which are fully indexed to quarterly changes in consumer prices. EI benefits are essentially unchanged. Beyond 2004–05, major transfers to persons increase in line with nominal GDP, reflecting growth in both elderly and EI benefits.

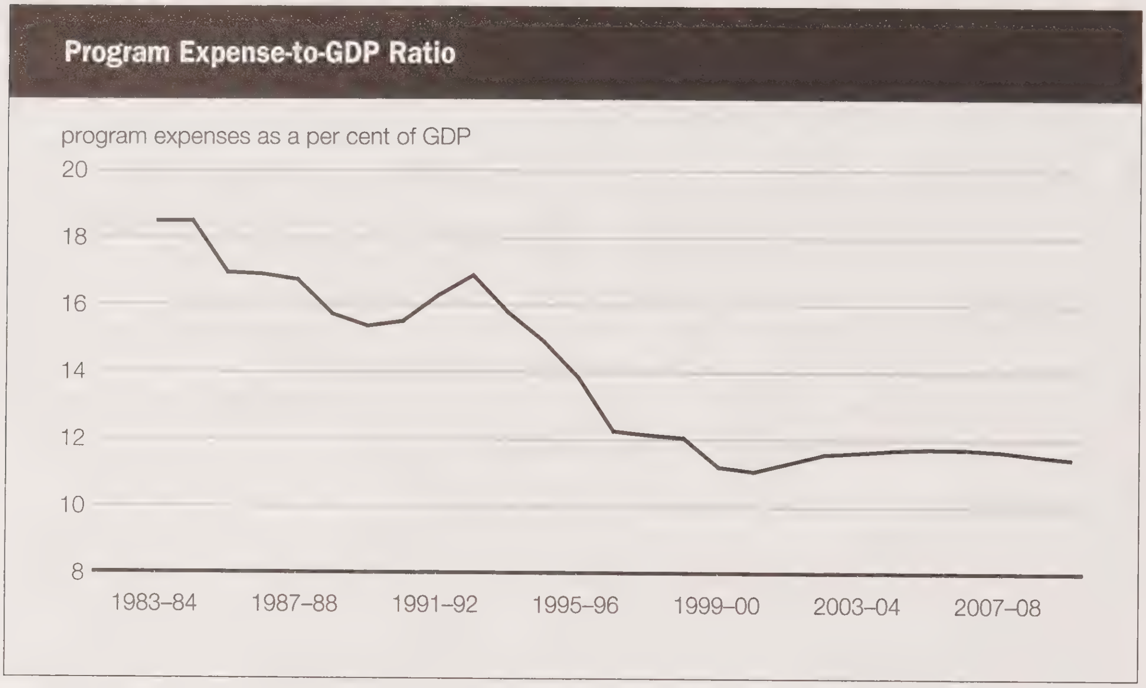
- Major transfers to other levels of government in 2004–05 are $4.3 billion (14.7 per cent) higher than in 2003–04, and are projected to grow by another $3.7 billion (11.0 per cent) in 2005–06. Growth in the outer years averages around 4 per cent per year. Transfers increase from $29.4 billion in 2003–04 to $44.1 billion in 2009–10. This is a 50-per-cent increase, almost double the growth in the other components of program spending over this period.

- Other program expenses are projected to grow by $4.0 billion, or 5.7 per cent, in 2004–05. In 2005–06, other program expenses are projected to grow by $3.6 billion, or 4.9 per cent. Over the remainder of the period, growth in spending is consistent with population growth plus inflation (except for components of program expenses that are clearly linked with economic factors).

- In December 2003 the Prime Minister launched the Expenditure Review Committee (ERC) to undertake an extensive and rigorous review of all government expenditures to ensure that government programs are better aligned with the priorities of Canadians and that they are delivered in the most cost-effective way.

- The ERC will identify total cumulative savings of $12 billion by 2009-10 from existing programs, which will be reallocated to fund new priorities. As in the March 2004 budget, these savings are not built into the status quo projections.

Program expense-to-GDP ratio



Sources: Department of Finance and Statistics Canada.

- Program expenses as a per cent of GDP are 11.6 per cent in 2004–05, unchanged from 2003–04.
- The ratio has declined significantly from the levels of the 1980s and early 1990s. This is primarily attributable to the expenditure reduction measures implemented in the 1995 and 1996 budgets, which structurally lowered program expenses. In light of the recent First Ministers' agreements on health, equalization and Territorial Formula Financing, this ratio is expected to remain relatively stable over the projection period.

Financial management and accountability

- In the March 2004 budget, the Government announced five significant new initiatives to strengthen financial management, oversight and accountability in departments and agencies. These initiatives are being carried out under the leadership of the President of the Treasury Board.

- On May 6, 2004, the Government announced the appointment of Mr. Charles-Antoine St-Jean as the new Comptroller General for Canada. The Comptroller General will provide overall leadership in ensuring that departments comply with Treasury Board policies for strong expenditure control and rigorous stewardship of public funds. The Comptroller General will review and sign off on policy proposals to ensure that expenditure plans are sound.

- Re-establishing the Office of the Comptroller General is a key part of the Government's effort to strengthen financial oversight across the federal government. Some of the initiatives the Comptroller General has chosen to undertake include:
  - Providing leadership to ensure appropriate frameworks, and policies and guidance on controls, are available across the federal public service.
  - Promoting transparency and openness of financial activity, including systems for accounting, asset management and procurement.
  - Building financial management and audit capacity to nurture and manage professional development of the financial management and internal audit communities, including establishing accreditation and certification standards and advising on the modules of the public service learning curriculum.

- The Government is working on the appointment of professionally accredited comptrollers to sign off on all new spending initiatives in every government department.

- The Government is also planning to introduce modern, real-time information systems to track all spending and provide appropriate tools for effective scrutiny and decision making. As an example, a new Expenditure Management Information System will integrate government-wide information and provide a common database for all departments, agencies and the Treasury Board Secretariat. This will enable on-line sharing of expenditure management and performance information. Information on Government of Canada contracts for goods and services over $10,000, and on the travel and hospitality expenses of political staff and senior Government of Canada officials, is now available on-line.

- Finally, the Government has undertaken a review of governance rules for Crown corporations. The results of the review will be released shortly.

Annex 4

Private Sector Five-Year Fiscal Projections: National Accounts–Public Accounts Reconciliation

Highlights

- *This annex provides detailed information on the translation of the five-year fiscal projections provided by the private sector forecasters from a National Accounts basis to a Public Accounts basis.*

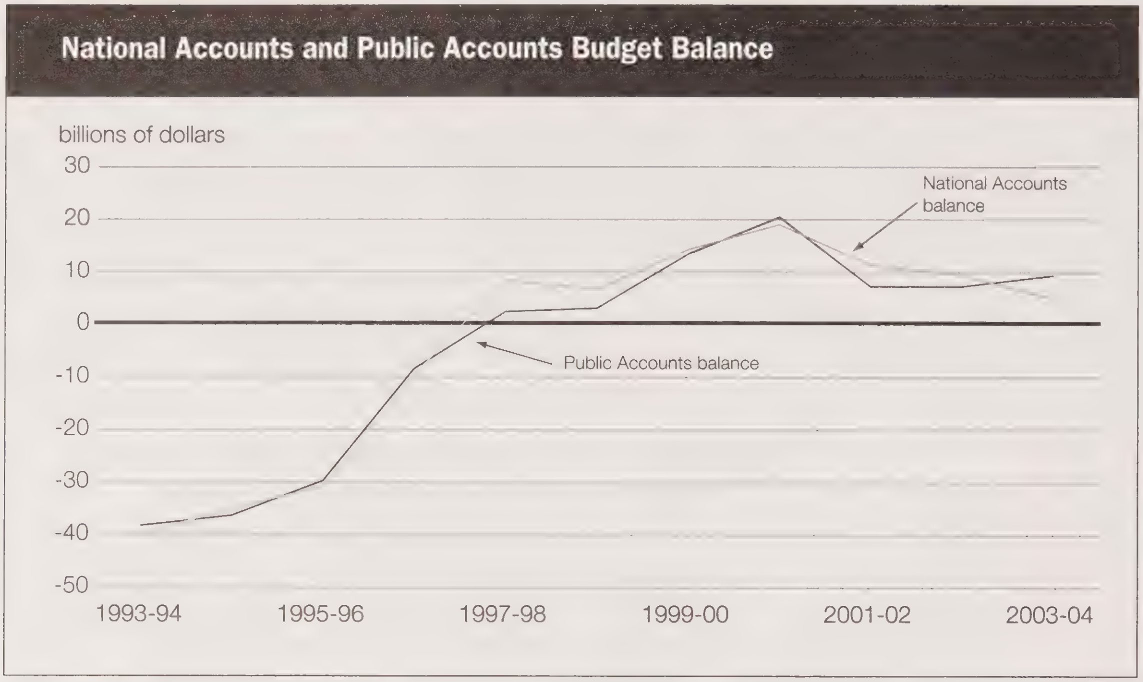
- *The National Accounts and the Public Accounts are the two key accounting frameworks that provide measures of the Government of Canada's revenues and expenses.*

- *Differences in the measures of the government sector arise because the two accounting frameworks are designed for different purposes: the National Accounts monitor the state and behaviour of the Canadian economy, whereas the Public Accounts are a snapshot of the Government's finances at a point in time.*

- *The Public Accounts of Canada provide detailed information to Parliament on the Government's financial position, as required under the Financial Administration Act. The Public Accounts follow Generally Accepted Accounting Principles, as set out by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants. Since 2002–03 the Public Accounts have been presented on a full accrual basis of accounting. Therefore revenues are recognized when they are earned and obligations when they are incurred.*

- *The System of National Accounts provides an integrated framework for measuring economic activity, including the activities of governments. It is based on international accounting conventions set out by the United Nations. As a result, the National Accounts measure of government financial positions provides a consistent framework in which comparisons can be made between the various levels of government in Canada as well as between countries.*

National Accounts and Public Accounts budget balance



- Differences in the National Accounts and Public Accounts frameworks reflect:
  - Differences related to the universe covered by each system. The Public Accounts include all departments, agencies, Crown corporations and funds, while the government sector in the National Accounts is, in the main, a subset of this universe based on ownership, control and funding criteria.
  - Conceptual and definitional differences related to the scope of each system. For example, the Public Accounts include revenues related to capital gains, asset sales and asset revaluations. The National Accounts record assets at market value and record changes in the values as they occur on the Government's balance sheet, but the gains and losses are not recorded in income. On a Public Accounts basis, they are recorded at the lower of the book or market value.
  - Timing differences related to the recording of various revenues and expenses. In the Public Accounts, a liability for payments to arm's-length organizations such as foundations and trusts is made in the year in which it is incurred. In the National Accounts, no obligation is recorded until the payment is made to the ultimate recipient.
- Both measures provide important and complementary perspectives on the Government's fiscal position. Although the measures differ in their levels, their trends are broadly similar.

Table 4.1

Average Private Sector Projection of the Budget Balance (National Accounts Basis)

	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(billions of dollars)						
Income and outlay account							
Income	200.5	208.2	216.2	226.4	236.5	247.1	257.9
Outlays	198.2	200.8	207.6	214.7	221.1	227.1	233.5
Savings	2.3	7.4	8.7	11.7	15.4	20.0	24.4
Capital and financial account							
Capital cost allowance	3.7	3.8	3.8	4.0	4.1	4.2	4.4
Net transfer of capital	1.7	1.8	1.8	1.7	1.7	1.6	1.6
Capital formation	-4.1	-4.7	-4.8	-4.9	-5.1	-5.3	-5.4
Total	1.4	0.9	0.8	0.8	0.6	0.6	0.6
Net lending	3.7	8.3	9.5	12.5	16.0	20.7	25.0
Reference							
Budget balance (Public Accounts basis)	9.1	12.8	9.5	11.6	15.2	20.3	25.3

- The National Accounts measure of the budget balance is net lending. This is the difference between total government income (revenues) and outlays (expenses), adjusted to reflect current expenses on capital as opposed to charges for depreciation.

- The following pages outline the adjustments required to translate each of the major revenue and expense components from a National Accounts basis to a Public Accounts basis.

Table 4.2
Average Private Sector Projection of Budgetary Revenues (National Accounts Basis)

	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)						
Personal income tax	88,938	90,385	96,198	102,516	109,114	116,164	123,453
Corporate income tax	29,942	33,623	34,103	35,110	35,275	35,117	35,269
Non-resident income tax	4,227	4,697	4,790	4,969	5,146	5,307	5,447
Employment insurance premiums	17,878	17,498	17,135	17,488	17,999	18,759	19,450
Goods and services tax	33,313	35,128	36,567	38,209	40,162	42,118	43,887
Customs import duties	2,943	2,840	2,939	3,108	3,243	3,440	3,518
Other excise taxes and duties	10,608	10,930	11,095	11,238	11,418	11,628	11,841
Investment income	7,060	7,201	7,465	7,681	7,905	8,170	8,450
Sales of goods and services and other[1]	5,583	5,935	5,954	6,070	6,226	6,400	6,587
Total	200,492	208,236	216,245	226,389	236,489	247,101	257,902

[1] Includes transfers from persons and transfers from other levels of government.

- The National Accounts provide a breakdown of revenue similar to that found in the Public Accounts. In translating these revenues to a Public Accounts basis, a number of adjustments are required. These include adjustments to reflect:
  - More up-to-date data on a Public Accounts basis.
  - The presentation of a number of revenue components in the Public Accounts net of tax expenditures such as the Canada Child Tax Benefit (CCTB) and the goods and services tax (GST) credit.
  - Differences in the definition of the government sector in the two accounting systems.
  - The inclusion of certain revenues in the Public Accounts that are not accounted for in the National Accounts, such as revenues from asset sales and the impact of revaluations of financial assets.
- The following section provides a detailed account of these adjustments for each major source of revenue.

Translation of National Accounts into Public Accounts

Table 4.3
Average Private Sector Projection of Personal Income Tax Revenues

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	87,296	88,938	90,385	96,198	102,516	109,114	116,164	123,453
Reclassifications								
CCTB	-7,879	-8,141	-8,797	-9,325	-9,671	-9,811	-9,917	-10,023
Trust income and other income tax	1,422	1,248	1,336	1,422	1,515	1,613	1,717	1,825
Interest and penalties	-1,483	-1,756	-1,849	-1,955	-2,074	-2,191	-2,309	-2,429
OAS income-tested repayments	-642	-718	-760	-802	-844	-886	-928	-970
Non-resident tax	-211	-162	-165	-175	-187	-199	-212	-225
GST employer rebate	116	120	122	130	138	147	157	167
Refundable tax credits	-63	-71	-73	-77	-82	-88	-93	-99
Year-to-date collections experience			3,350	3,565	3,799	4,044	4,305	4,575
Other	3,251	5,437	5,707	6,076	6,485	6,921	7,389	7,873
Net adjustments	-5,589	-4,043	-1,128	-1,191	-919	-448	109	694
Average private sector—Public Accounts	81,707	84,895	89,257	95,056	101,597	108,665	116,273	124,147

- Various reclassifications are required to translate the National Accounts projection of personal income tax revenues to the accrual Public Accounts projection. The most important of these is to deduct the value of the CCTB from National Accounts revenues. In the Public Accounts, personal income tax revenues are presented net of the CCTB. The CCTB projection is based on forecasts of population growth, income profiles and the impact of measures to enhance the benefit announced in past budgets.

- Other reclassifications involved in moving to the Public Accounts definition of personal income tax revenues include:
  - Adding tax revenues related to trust income.
  - Deducting interest and penalties, which are counted in non-tax revenues in the Public Accounts.
  - Deducting Old Age Security (OAS) benefit repayments, which are netted against OAS benefits in the Public Accounts.
  - Deducting the non-resident withholding tax imposed on persons, which is shown separately in the Public Accounts.
  - Deducting personal refundable tax credits.

- These adjustments are generally assumed to grow with National Accounts personal income tax revenues over the planning period.

- Next, year-to-date collections experience is incorporated to ensure the projection reflects the most up-to-date information available. Fiscal data through September 2004 suggest that personal income tax receipts will increase by about 5 per cent in 2004–05. The private sector projections were increased by $3.4 billion in 2004–05 to achieve this growth. In future years, this adjustment is assumed to grow in line with the personal income tax base. As a result, the growth in personal income tax revenues in future years is consistent with the growth forecast by the private sector forecasters.

- Other adjustments are largely due to the fact that the latest National Accounts estimates do not reflect the final year-end fiscal numbers found in the 2003–04 Public Accounts.

Translation of National Accounts into Public Accounts

Table 4.4
Average Private Sector Projection of Corporate Income Tax Revenues

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	26,180	29,942	33,623	34,103	35,110	35,275	35,117	35,269
Reclassifications								
Interest and penalties	111	-22	-23	-24	-24	-24	-24	-24
Refundable tax credits	-355	-686	-770	-781	-804	-808	-804	-808
One-time factors		2,500						
Other	-3,714	-4,303	-4,804	-4,873	-5,017	-5,040	-5,018	-5,039
Net adjustment	-3,958	-2,511	-5,598	-5,678	-5,845	-5,873	-5,846	-5,872
Average private sector—Public Accounts	22,222	27,431	28,025	28,426	29,265	29,403	29,270	29,397

- The main reclassifications involved in translating corporate income tax revenues from a National Accounts to a Public Accounts basis are the deduction of the corporate refundable tax credits, which are netted against revenues in the Public Accounts, and the removal of interest and penalties, which are reported as other non-tax revenues in the Public Accounts. These are projected to grow in line with corporate income tax collections over the planning period.

- An adjustment is made for the one-time gain in corporate income tax receipts from the financial services industry in 2003–04. This gain was related to downward revaluations of U.S.-dollar-denominated liabilities as a result of the increase in the value of the Canadian dollar. To reflect the one-time nature of these gains, the starting point for the private sector projections is adjusted down by $2.5 billion.

- Remaining adjustments reflect the fact that corporate tax liabilities in the National Accounts are based on a quarterly survey of corporate profits, while in the Public Accounts they are based on assessed corporate income tax. This adjustment is projected to grow in line with National Accounts corporate income tax revenues over the planning period.

Translation of National Accounts into Public Accounts

Table 4.5
Average Private Sector Projection of Non-Resident Withholding Tax and Other Income Tax

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	4,364	4,227	4,697	4,790	4,969	5,146	5,307	5,447
Reclassifications								
Trust income and other income tax	-1,422	-1,248	-1,336	-1,422	-1,515	-1,613	-1,717	-1,825
Non-resident tax	211	162	165	175	187	199	212	225
Other	138	1						
Net adjustment	-1,073	-1,085	-1,172	-1,247	-1,328	-1,414	-1,506	-1,600
Average private sector—Public Accounts	3,291	3,142	3,525	3,543	3,641	3,732	3,801	3,847

- The main adjustment involved in translating the non-resident withholding tax from a National Accounts to a Public Accounts basis is the removal of tax on trust income included in the National Accounts estimate. This is included in personal income tax revenues in the Public Accounts. Tax on trust income and other income tax are projected to grow in line with National Accounts personal income tax revenues.

Translation of National Accounts into Public Accounts

Table 4.6
Average Private Sector Projection of Goods and Services Tax Revenues

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	31,607	33,313	35,128	36,567	38,209	40,162	42,118	43,887
Reclassifications								
GST credit	-3,184	-3,281	-3,361	-3,429	-3,498	-3,569	-3,640	-3,714
GST employer rebate	-116	-120	-122	-130	-138	-147	-157	-167
Year-to-date collections experience			-450	-468	-489	-514	-539	-562
Other	-59	-1,626	-1,697	-1,767	-1,846	-1,940	-2,035	-2,120
Net adjustments	-3,359	-5,027	-5,630	-5,794	-5,972	-6,171	-6,371	-6,563
Average private sector—Public Accounts	28,248	28,286	29,498	30,773	32,237	33,991	35,747	37,324

- The key adjustment required to translate GST revenues from a National Accounts to a Public Accounts basis is the subtraction of the GST credit from National Accounts revenues. The National Accounts report GST receipts gross of the credit, while the budgetary presentation in the Public Accounts is net of the credit. The GST credit is projected on the basis of expected increases in population, income profiles and benefits.

- The average private sector projection of GST revenues is adjusted downward to reflect GST collections experience in 2004–05. Over the remainder of the projection, the adjustment grows in line with the consumption base.

- Of the remaining adjustments, the most important involves replacing the accrual adjustment contained in the National Accounts, which is based on a model of taxable expenditures, with the Public Accounts accrual estimate based on assessed receipts, rebates and refunds. This adjustment factor is projected to grow in line with National Accounts GST revenues over the planning period.

Translation of National Accounts into Public Accounts

Table 4.7
Average Private Sector Projection of Customs Import Duties

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)							
Average private sector— National Accounts	3,176	2,943	2,840	2,939	3,108	3,243	3,440	3,518
Adjustment	102	-56	-55	-57	-60	-63	-67	-68
Average private sector— Public Accounts	3,278	2,887	2,785	2,882	3,048	3,180	3,373	3,450

- The estimates of customs import duties are very similar under the two accounting systems.
- The main adjustment required to move from a National Accounts basis to a Public Accounts basis is to replace Statistics Canada's accrual adjustment related to the timing of receipts with the assessment-based accrual estimates contained in the Public Accounts. This adjustment is assumed to grow in line with National Accounts customs import duties over the planning period.

Translation of National Accounts into Public Accounts

Table 4.8
Average Private Sector Projection of Other Excise Taxes and Duties

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector— National Accounts	10,293	10,608	10,930	11,095	11,238	11,418	11,628	11,841
Adjustment	-462	-416	-440	-464	-471	-461	-449	-441
Average private sector— Public Accounts	9,831	10,192	10,490	10,631	10,767	10,957	11,179	11,400

- The two key components of other excise taxes and duties are tobacco taxes and motive fuel taxes. The estimates of these tax bases are similar in the two accounting systems.

- The adjustment in translating other excise taxes and duties from a National Accounts to a Public Accounts basis largely reflects the exclusion of an accrual adjustment made in the Public Accounts accrual figures to reflect underlying taxes assessed.

Translation of National Accounts into Public Accounts

Table 4.9
Average Private Sector Projection of Employment Insurance Premium Revenues

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	18,260	17,878	17,498	17,135	17,488	17,999	18,759	19,450
Reclassifications								
Federal government as employer	-373	-355	-331	-331	-337	-347	-362	-375
Other	-17	23	23	23	23	23	23	23
Net adjustments	-390	-332	-308	-308	-314	-324	-339	-352
Average private sector—Public Accounts	17,870	17,546	17,190	16,827	17,174	17,675	18,420	19,098

- Translating employment insurance (EI) premium revenues from a National Accounts to a Public Accounts basis involves removing the premiums paid by the federal government as an employer from the National Accounts estimate, as they are netted out of both revenues and expenses on a Public Accounts basis.

Translation of National Accounts into Public Accounts

Table 4.10
Average Private Sector Projection of Net Crown Corporation Revenues, Foreign Exchange Revenues, and Return on Investments

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	6,922	7,060	7,201	7,465	7,681	7,905	8,170	8,450
Reclassifications								
Agencies, funds and foundations	-694	-695	-698	-718	-739	-760	-782	-805
Interest on overdue accounts	-150	-127	-128	-131	-135	-139	-143	-147
Royalties	-500	-553	-568	-579	-594	-610	-626	-642
Revaluations and net gains/losses	289	264	-590					
Crown corporations	1,375	2,266	1,859	1,314	1,356	1,401	1,448	1,499
Other	236	-835	-1,372	-1,175	-899	-735	-716	-685
Net adjustments	556	320	-1,497	-1,290	-1,011	-843	-819	-780
Average private sector—Public Accounts	7,478	7,380	5,704	6,175	6,670	7,062	7,351	7,670

- The National Accounts concept of return on investments is considerably different than the Public Accounts concept. The key differences between the two are highlighted here.
  - First, the National Accounts include the interest earnings of a number of entities that are not considered part of the Government of Canada for the purpose of the Public Accounts, including interest earnings of trusts and foundations set up as third parties.
  - Second, royalties are included on a National Accounts basis as a return on the rental of an asset, while on a Public Accounts basis royalties are included in sales of goods and services.
  - Third, revaluations (largely foreign exchange-related revaluations) and gains and losses on sales are not included in current income on a National Accounts basis but are included on a Public Accounts basis.
  - Fourth, the National Accounts do not include the unremitted profits of enterprise Crown corporations in current income, but these are included on a Public Accounts basis.
  - Fifth, other estimates reduce the projected growth in the Public Accounts estimate in 2004–05, reflecting the impact of the forecast decline in short-term interest rates on the return on the Government's assets. This impact is diminished over time, consistent with the expected increase in U.S. short-term interest rates and ongoing growth in the stock of Canada Student Loans.

Translation of National Accounts into Public Accounts

Table 4.11
Average Private Sector Projection of Sales of Goods and Services and Other Non-Tax Revenues

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)							
Average private sector— National Accounts	5,377	5,583	5,935	5,954	6,070	6,226	6,400	6,587
Reclassifications								
External revenue netted against expenditures	-3,020	-3,076	-3,141	-3,151	-3,212	-3,295	-3,387	-3,486
Interest and penalties	1,781	1,974	2,078	2,196	2,328	2,458	2,590	2,722
Petro-Canada	–	–	2,562	–	–	–	–	–
Royalties	500	553	716	715	739	946	903	918
Youth Allowance Recovery	-518	-595	-590	-611	-647	-687	-728	-781
Subtotal	-1,257	-1,144	1,626	-851	-791	-578	-622	-627
Other	-213	10	11	11	11	11	11	12
Net adjustments	-1,470	-1,134	1,636	-840	-781	-567	-610	-615
Average private sector— Public Accounts	3,907	4,449	7,571	5,114	5,289	5,659	5,789	5,972

- In the Public Accounts, departmental revenues that are levied for specific services, such as contract costs of policing services in provinces, are netted against expenses, whereas in the National Accounts they are presented on a gross basis.
- Interest and penalties related to overdue taxes must be added as these are included in other non-tax revenues in the Public Accounts, but classified with their respective revenues in the National Accounts. These revenues are forecast to grow with either the corresponding tax base or tax revenues.
- In addition, revenues from the sale of the Government's remaining shares in Petro-Canada are not included in the National Accounts and thus must be added in 2004–05.
- Royalties are added to the National Accounts estimate as these are included in the Public Accounts sales.
- The Youth Allowance Recovery (YAR) must be deducted from the National Accounts revenues as the YAR is presented on a net basis in the Public Accounts.

Table 4.12
Average Private Sector Projection of Federal Government Expenses (National Accounts Basis)

	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)						
Federal government expenses							
Goods and services	49,585	52,494	54,678	55,778	57,503	59,304	61,146
Current transfers							
To persons							
OAS benefits	27,277	28,211	29,333	30,483	31,727	33,133	34,615
EI benefits	13,483	13,311	13,478	13,912	14,347	15,063	15,650
CCTB	8,141	8,797	9,325	9,671	9,811	9,917	10,023
GST credit	3,281	3,361	3,429	3,498	3,569	3,640	3,714
Other	11,436	12,538	13,483	14,031	14,462	14,876	15,345
To business	4,732	4,193	4,287	4,442	4,547	4,617	4,697
To non-residents	3,324	3,590	3,877	4,187	4,522	4,884	5,275
To other levels of government							
Federal transfer support for health and other social programs	22,678	21,394	21,956	23,435	24,848	25,853	26,946
Equalization	10,104	9,865	9,510	9,510	9,510	9,510	9,510
Other	9,482	9,576	9,458	9,769	9,888	10,104	10,351
Interest on public debt	34,640	33,469	34,765	35,945	36,345	36,153	36,195
Total outlays	198,163	200,799	207,580	214,660	221,078	227,054	233,467

- The National Accounts concept of total outlays corresponds to the Public Accounts expenses, including public debt charges. The National Accounts include all major transfers to persons, such as OAS and EI benefits, as well as other transfers to persons, such as programs supporting research and students and transfers to Aboriginal peoples and organizations. The National Accounts also include the CCTB and the GST credit as transfers to persons.

- Transfers to other levels of government, including transfers in support of health care and equalization, are part of National Accounts total outlays. Other transfers to other levels of government include transfers in support of labour training and infrastructure.

- Business subsidies, transfers to non-residents and interest on the public debt are also part of National Accounts total outlays.

Translation of National Accounts into Public Accounts

Table 4.13
Average Private Sector Projection of Elderly Benefits

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector— National Accounts	25,955	27,277	28,211	29,333	30,483	31,727	33,133	34,615
Reclassifications								
Payments to non-residents	330	343	352	362	372	382	391	401
Income-tested repayments	-642	-718	-760	-802	-844	-886	-928	-970
Subtotal	-312	-375	-409	-440	-472	-504	-537	-569
Other	49							
Net difference	-263	-375	-409	-440	-472	-504	-537	-569
Average private sector— Public Accounts	25,692	26,902	27,802	28,893	30,011	31,222	32,596	34,046

- Translating elderly benefits from a National Accounts to a Public Accounts basis involves adding OAS payments to non-residents to the National Accounts estimates. In the National Accounts these are treated as transfers to non-residents.

- The impact of income testing OAS payments for pensioners with an individual net income above $59,790, which is done through the tax system at tax filing time, is not included in total OAS payments on a National Accounts basis. This impact is reflected in a reduction of personal income taxes on a National Accounts basis. On a Public Accounts basis, OAS payments are reported net of the impact of income testing.

Translation of National Accounts into Public Accounts

Table 4.14
Average Private Sector Projection of Employment Insurance Benefits

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)							
Average private sector—National Accounts	12,830	13,483	13,311	13,478	13,912	14,347	15,063	15,650
Reclassifications								
Employment benefits and support measures	855	749	873	884	912	941	988	1,026
EI transfers to provinces	893	894	895	906	935	965	1,013	1,052
	1,648	1,528	1,668	1,690	1,744	1,800	1,891	1,961
Other	-82	-67	-67	-67	-70	-72	-75	-78
Net adjustments	1,666	1,575	1,701	1,703	1,777	1,834	1,925	2,000
Average private sector—Public Accounts	14,496	15,058	15,012	15,201	15,689	16,182	16,988	17,650

- Translating employment benefits from a National Accounts basis to a Public Accounts basis requires the following two adjustments.
  - The National Accounts estimate includes only those employment benefit and support measures (EBSMs) that the System of National Accounts considers to be direct transfers to persons, which represent about one-third of total EBSM spending. In the National Accounts the other two-thirds of the cost of EBSMs is attributed to the respective recipients (e.g., businesses, other levels of government), while all EBSM spending is included in the Public Accounts estimate.
  - The cost of transfers to provinces funded out of the EI program are included as transfers to provinces in the National Accounts. These need to be included in translating to a Public Accounts basis.

Translation of National Accounts into Public Accounts

Table 4.15
Average Private Sector Projection of Federal Transfer Support for Health and Other Social Programs

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Average private sector—National Accounts	16,252	22,678	21,394	21,956	23,435	24,848	25,853	26,946
Reclassifications								
Alternative Payments for Standing Programs	2,321	2,700	2,668	2,765	2,929	3,111	3,296	3,535
Accrual adjustments								
Medical Equipment Trust Fund	1,500	-1,500						
2002–03 CHST supplement	2,500	-2,484						
2003–04 CHST supplement		1,393	-1,393					
Public Health and Immunization Trust		400	-400					
Subtotal	4,000	-2,191	-1,793					
Other	27	-446	-219	4	36	91	101	69
Net adjustments	4,848	63	656	2,769	2,965	3,202	3,397	3,604
Average private sector—Public Accounts	22,600	22,741	22,050	24,725	26,400	28,050	29,250	30,550

- For 2002–03 and 2003–04 transfers to other levels of government on a National Accounts basis include the Canada Health and Social Transfer (CHST) as well as transfers to the Medical Equipment Trust Fund and the Public Health and Immunization Trust. Starting in 2004–05 the new Canada Health Transfer and Canada Social Transfer replace the CHST.

- In order to move from the National Accounts projection to the Public Accounts projection, the following adjustments must be made:
  - Amounts for Alternative Payments for Standing Programs must be added to the National Accounts projection, since the National Accounts nets this amount off of the CHST.
  - Numerous timing adjustments are required since the National Accounts record the expenditures when the payments are actually made to the trust funds, whereas the Public Accounts record when the liability for these amounts is incurred. These timing differences between the accounts arise due to payments made for the Medical Equipment Trust Fund, CHST supplements and the Public Health and Immunization Trust.
  - Differences may also arise between these series because the latest National Accounts do not reflect the final year-end fiscal numbers found in the 2003–04 Public Accounts.

Translation of National Accounts into Public Accounts

Table 4.16
Average Private Sector Projection of Fiscal Transfers

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)							
Average private sector— National Accounts	10,484	10,104	9,865	9,510	9,510	9,510	9,510	9,510
Reclassifications								
Territorial Formula Financing	1,504	1,792	1,800	1,800	1,800	1,800	1,800	1,800
Statutory subsidies	31	32	32	32	32	32	32	32
Youth Allowance Recovery	-518	-595	-590	-611	-647	-687	-728	-781
Subtotal	1,017	1,229	1,242	1,221	1,185	1,145	1,104	1,051
Accrual adjustments								
Provision for valuation	-1,401	-2,009	-355					
Other	266	27						
Net adjustments	-118	-753	887	1,221	1,185	1,145	1,104	1,051
Average private sector— Public Accounts	10,366	9,351	10,752	10,731	10,695	10,655	10,614	10,561

- Fiscal transfers on a National Accounts basis consist of equalization. To translate this to the Public Accounts basis requires adding amounts for Territorial Formula Financing, Youth Allowance Recoveries and statutory subsidies.

- Accrual adjustments are required since the National Accounts reflect equalization cash payments, whereas the Public Accounts reflect equalization entitlements.

- Other adjustments reflect the fact that the National Accounts do not include the final year-end fiscal numbers.

Translation of National Accounts into Public Accounts

Table 4.17
Average Private Sector Projection of Direct Program Spending

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
				(millions of dollars)				
Other program spending								
Current expenses on goods and services	46,206	49,585	52,494	54,678	55,778	57,503	59,304	61,146
Other programs								
Other transfers to persons	11,284	11,436	12,538	13,484	14,031	14,462	14,877	15,345
Subsidies	3,501	4,732	4,193	4,287	4,442	4,547	4,617	4,697
Transfers to non-residents	3,052	3,324	3,590	3,877	4,187	4,522	4,884	5,275
Other transfers to other levels of government	8,466	9,482	9,576	9,458	9,769	9,888	10,104	10,351
Spending included in the capital and financial account								
Capital cost allowance	-3,654	-3,718	-3,757	-3,832	-3,954	-4,078	-4,228	-4,368
Net transfer of capital	-1,510	-1,743	-1,785	-1,756	-1,717	-1,677	-1,636	-1,593
Capital formation	3,604	4,106	4,665	4,786	4,915	5,123	5,259	5,400
National Accounts—other program spending	70,949	77,204	81,513	84,982	87,450	90,289	93,181	96,254
Reclassifications and other adjustments								
Elderly payments to non-residents	-330	-344	-352	-362	-372	-382	-391	-401
Employment support benefits	-1,748	-1,643	-1,770	-1,764	-1,763	-1,769	-1,769	-1,769
Federal government EI contributions	-373	-355	-331	-331	-337	-347	-362	-375
Veterans' benefits	-1,636	-1,708	-1,681	-1,715	-1,749	-1,784	-1,820	-1,856
Territorial Formula Financing	-1,511	-1,702	-1,800	-1,800	-1,800	-1,800	-1,800	-1,800
Statutory subsidies	-31	-32	-32	-32	-32	-32	-32	-32
External revenue netted against expenditures	-3,020	-3,076	-3,141	-3,151	-3,212	-3,295	-3,387	-3,486
Consolidated Crown corporation expenses	-1,557	-1,201	-1,237	-1,274	-1,312	-1,352	-1,392	-1,434
Refundable tax credits	-418	-757	-843	-858	-886	-896	-898	-907
Bad debt expense	1,563	2,525	2,677	2,766	2,985	3,136	3,145	3,207
Federal employee pensions	1,215	2,014	2,365	2,767	3,162	3,928	4,114	4,133
Amortization of tangible capital assets	3,341	3,502	3,670	3,757	4,031	4,224	4,427	4,540
Non-financial capital acquisition	-3,604	-4,106	-4,665	-4,786	-4,915	-5,123	-5,259	-5,400
Other	-80	-318	-763	-964	0	0	0	0
Net adjustments	-8,189	-7,201	-7,903	-7,747	-6,202	-5,491	-5,424	-5,581
Public Accounts—direct program spending	62,760	70,003	73,611	77,235	81,248	84,799	87,758	90,673

- Direct program spending in the National Accounts consists of federal government expenses on goods and services, other transfers to persons and other transfers to other levels of government, as well as transfers to business and non-residents (see Table 4.12 for details). Also included are components for capital to put other program spending on a consistent basis with the concept of net lending.

- A number of adjustments are needed to reflect differences in the universe of programs included in the National Accounts and the Public Accounts.
  - Payments of elderly benefits and EI employment support benefits to non-residents are deducted from the National Accounts estimates because these are included in the Public Accounts estimates of OAS benefits and EI benefits respectively.
  - The federal government's payment of EI premiums as an employer are deducted from the National Accounts estimates.
  - Veterans' benefits are deducted from the National Accounts estimate of direct program spending because, on a Public Accounts basis, the cost of providing veterans' benefits is accounted for as an interest charge on the liability.
  - Spending on Territorial Formula Financing and statutory subsidies is deducted from the National Accounts estimate as these are included in transfers to other levels of government on a Public Accounts basis.
  - Departmental revenues that are levied for specific services are deducted from the National Accounts estimate because these are netted against expenses in the Public Accounts.
  - The expenditures of Crown corporations in the National Accounts are also presented on a gross basis. Therefore an adjustment is required in translating these to the Public Accounts, in which the expenses of consolidated Crown corporation expenses are presented net of revenues generated by these corporations.
  - The value of refundable tax credits is deducted from the National Accounts estimate of direct program spending, as these are netted against the applicable tax revenues in the Public Accounts.
  - An amount must also be added to the National Accounts estimate to reflect the liability recognized in the Public Accounts for debt in arrears that the Government does not expect to collect.
  - An adjustment is required to align the estimate of the federal public sector pensions included in the National Accounts with the actual cost of the pensions recorded in the Public Accounts.
  - Similarly, an adjustment is required to account for differences in the depreciation costs included in the two accounting systems, which stem from differences in estimates of the capital stock of the federal government.
  - Other adjustments arise in large measure because the latest National Accounts do not reflect the final year-end fiscal numbers found in the 2003–04 Public Accounts and the estimate of direct program spending for 2004–05 and 2005–06 in the 2004 budget.

Table 4.18
Average Private Sector Projection of Public Debt Charges

	Actual 2002–03	Actual 2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
	(millions of dollars)							
Average private sector—National Accounts	36,296	34,640	33,469	34,765	35,945	36,345	36,153	36,195
Reclassifications								
Capital lease obligations	146	156	140	140	140	140	140	140
Servicing cost and costs of issuing new borrowings	119	91	117	117	117	117	117	117
Timing of payments/accrual adjustments								
Pension interest adjustment	-1,687	-1,519	-1,559	-1,678	-1,801	-1,930	-2,074	-2,087
Other employee and veterans' benefits	2,240	2,309	2,408	2,451	2,483	2,513	2,542	2,604
Other	156	92	92	92	92	92	92	92
Net adjustments	974	1,129	1,198	1,122	1,031	932	817	866
Average private sector—Public Accounts	37,270	35,769	34,667	35,887	36,976	37,277	36,970	37,061

- Two major accrual adjustments are made to the National Accounts in order to reconcile the two projections:
  - First, the National Accounts estimate of interest on pension liabilities is adjusted to incorporate returns on pension fund assets and the interest on the average actuarial obligation.
  - Second, the National Accounts record payments for employee benefits, post-employment benefits and veterans' pensions in other program spending, whereas for the Public Accounts, public debt charges include the interest on liabilities for these programs.
- Other adjustments arise between these series because the latest National Accounts do not reflect the final year-end fiscal numbers found in the 2003–04 Public Accounts.